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Abolishing of the VAT exemption for the simplified tax system

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Executive Summary

Based on 2024 data, the simplified tax system (STS) covers approximately **1.5 m private entrepreneurs (PEs)** and generates around **UAH 2.5 tn (~EUR 50 bn) in reported turnover**. The regime is predominantly used by businesses operating in **wholesale and retail trade (including vehicle repair)**, which account for around **559 thsd PEs (38% of all STS participants)** and generate **UAH 1.2 trillion in turnover (49% of total STS turnover)**. A substantial majority of these entrepreneurs (**around 68%**) operate under **Group 2**, which is subject to a **fixed monthly tax of up to UAH 1,420 (as of 2024)**, regardless of actual turnover.

As of 2026, the STS thresholds and tax parameters differ from 2024 (e.g., Group 2 monthly tax amounts to UAH 1,730). A limitation of the analysis is that it relies on 2024 data, as the **available statistics on the distribution of PEs by number and turnover are reported for 2024**, ensuring consistency across the analysis.

Both our calculations and the case studies presented in this paper indicate that the highest concentration of business fragmentation is observed primarily in the **trade sector, as well as in HoReCa and manufacturing**. The most prevalent practices include artificial splitting and multiplication of PEs, concealed turnover, grey imports, and non-transparent product origin, particularly in goods-related activities. It is important to distinguish between two conceptually different phenomena: **tax avoidance and tax evasion**. Tax avoidance refers to formally legal optimisation strategies that rely on design features and loopholes of the current tax framework, allowing economically integrated businesses to minimise their effective tax burden while remaining within the law. Tax evasion, by contrast, involves illegal practices such as smuggling, concealed turnover, and non-transparent product origin, which directly undermine tax compliance, consumer protection, and fair competition. These two dimensions require distinct policy responses. Tax avoidance reflects structural weaknesses in the design of the STS, while tax evasion points to enforcement and compliance failures. Effective reform therefore depends on addressing their interaction rather than treating them as a single phenomenon. As a result, the STS has, to a significant extent, evolved beyond its original purpose. While initially designed to support genuinely micro-scale businesses in entering the formal economy and gradually scaling up, the regime now functions as a structural enabler of both tax avoidance and, in some sectors, tax evasion, particularly in trade in goods. This transformation undermines tax neutrality, distorts competition between compliant and non-compliant businesses, and weakens consumer protection, as non-compliant models are able to undercut prices while avoiding basic guarantees of quality and origin.

These distortions are not incidental but systemic, pointing to the need for **structural reform of the STS design**. From a tax policy perspective, several policy responses to these distortions are theoretically available. However, comparative analysis indicates that **removing the VAT exemption through the introduction of a single mandatory VAT registration threshold is the most balanced option** in terms of economic efficiency, administrative feasibility, and proportionality of impact on compliant businesses. This approach is also **structurally unavoidable in the context of EU legal harmonisation**. Council Directive 2006/112 places a central emphasis on **VAT neutrality and the universal application of VAT thresholds to economically comparable activities**, irrespective of legal

form or special tax regime. While technical variations are possible, **economically identical businesses cannot remain subject to fundamentally different VAT treatment** without undermining competitive neutrality.

In practice, VAT is already embedded in purchase prices for non-VAT payers and functions as a **non-recoverable cost component**. VAT registration converts this implicit tax into an **input VAT credit**, thereby restoring VAT's core function as a **neutral tax on value added**. Empirical evidence confirms that the **effective impact of this approach is concentrated precisely in sectors with the highest incidence of abuse**, rather than among genuinely small businesses. Attempts to target only "problematic" sectors through **sector-specific thresholds or special rules** generate significant administrative challenges. Activity classification, oversight of mixed business models, and the scope for discretionary reclassification of taxpayers inevitably create **new competitive distortions**. International practice and UN DESA guidance (United Nations (UN), 2024a) consistently show that **universal turnover-based thresholds dominate sector-specific approaches** in terms of enforceability and neutrality. Importantly, the **VAT registration threshold is not equivalent to total business turnover**. Certain transactions, including exports of services and other supplies outside the scope of VAT, are excluded from the threshold calculation. This design feature allows protection of low-risk activities while preserving the developmental role of the STS for genuinely small enterprises. Ukraine has a **limited but sufficient window** to prepare for implementation. A predictable transition period allows VAT administration to be adapted, digital tools to be scaled up, and discretionary enforcement risks to be reduced. Failure to use this preparation period would materially increase implementation risks.

To ensure effectiveness, the reform should be accompanied by the following measures:

1. **Calibration of the VAT threshold.** The mandatory VAT registration threshold should be increased from UAH 1 m to UAH 2.5 m. This level aligns with the observed distribution of turnover, protects genuinely small businesses from disproportionate compliance costs, and does not reduce the cost of artificial fragmentation schemes.
2. **Administrative simplification.** Expanding the VAT base must be accompanied by lower compliance costs, including the use of the cash accounting method, simplified input VAT registration, and standardised digital reporting tools.
3. **Creating fiscal space for future VAT rate reductions.** Restoring the integrity of the VAT chain creates the fiscal preconditions for revisiting VAT rates on basic food products and socially significant goods, where Ukraine's current standard rate is among the highest in Europe. Such reductions are feasible only after closing major channels of VAT leakage.
4. **Reconfiguration of the STS.** Groups 1 and 2 should be merged, replacing fixed lump-sum payments with mechanisms linked to actual turnover. Current turnover ceilings for Groups 2 and 3 are economically understated and misaligned with international benchmarks. Once a single VAT threshold is introduced and fixed payments are removed, turnover limits within the STS should be increased to reduce incentives for artificial growth suppression and business fragmentation.

With appropriate design, **mandatory VAT registration within the STS framework has a positive impact on microbusinesses**. It restores tax neutrality, formalises VAT already embedded in prices, reduces incentives for informality, and levels the playing field between economically comparable business models. This is **not a punitive measure**, but a **structural correction** aimed at preserving the simplified regime for genuine micro-entrepreneurship while eliminating its use as a vehicle for tax arbitrage.

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1. Introduction

The reform of the simplified tax system (STS) has become a priority in the context of Ukraine's cooperation with the IMF under the Extended Fund Facility (EFF). A core element of the proposed reform is the removing of mandatory VAT registration exemption for STS taxpayers whose annual turnover exceeds the general VAT threshold of UAH 1 m. Submitting the draft law to Parliament will fulfill the IMF prior action, while its adoption (planned by the end of March 2026) will mark the implementation of the IMF milestone. The reform itself is scheduled to take effect in 2027. By introducing mandatory VAT registration for STS taxpayers, the IMF's proposal aims to strengthen compliance and reduce opportunities for tax evasion and avoidance. In our previous 2021 (Gaidai et al. 2021), we already highlighted the problem of abusing the current STS design through loopholes and illegal practices by companies seeking to stay below STS turnover limits. This results in foregone tax revenues of over UAH 1 trillion due to shadow schemes in Ukraine (Kapustinska, 2026) and leads to significant distortions in market competition, placing compliant businesses at a disadvantage.

This paper provides an analytical assessment of the STS and presents evidence that its current design has evolved into a regime that economic agents actively seek to remain in. The analysis focuses on how VAT exemption shapes the behaviour of private entrepreneurs, generates incentives for tax avoidance and, in some cases, tax evasion, and rises to competitive and investment distortions. The paper evaluates how the proposed introduction of VAT would affect business operations and economic activity of STS actors and integration into VAT supply chains. The next chapter describes the key features of the STS functioning, highlighting the sectors that dominate in each group and the turnover scales under the STS. It also presents statistical evidence on tax avoidance and examines how the current system design influences the behavior of businesses and individuals, creating the incentives for participation in the informal economy. Then, Chapter 3 examines the proposed VAT reform, including alternative options that could be used to address current issues. It compares Ukraine's approach with EU practices and identifies gaps in the current policy. In this chapter we also evaluated the potential effects of the reform, analyzing different groups of taxpayers and detailing the expected impact on goods and services, as well as on exports and imports. Chapter 4 focuses on the practical aspects of implementing the reform and the main challenges that may arise. Finally, Chapter 5 provides policy recommendations aimed at using the transition period to ensure an orderly adjustment of businesses and institutions to the new VAT framework.

2. Current system description and its role in the shadow economy

2.1. Description of the current system

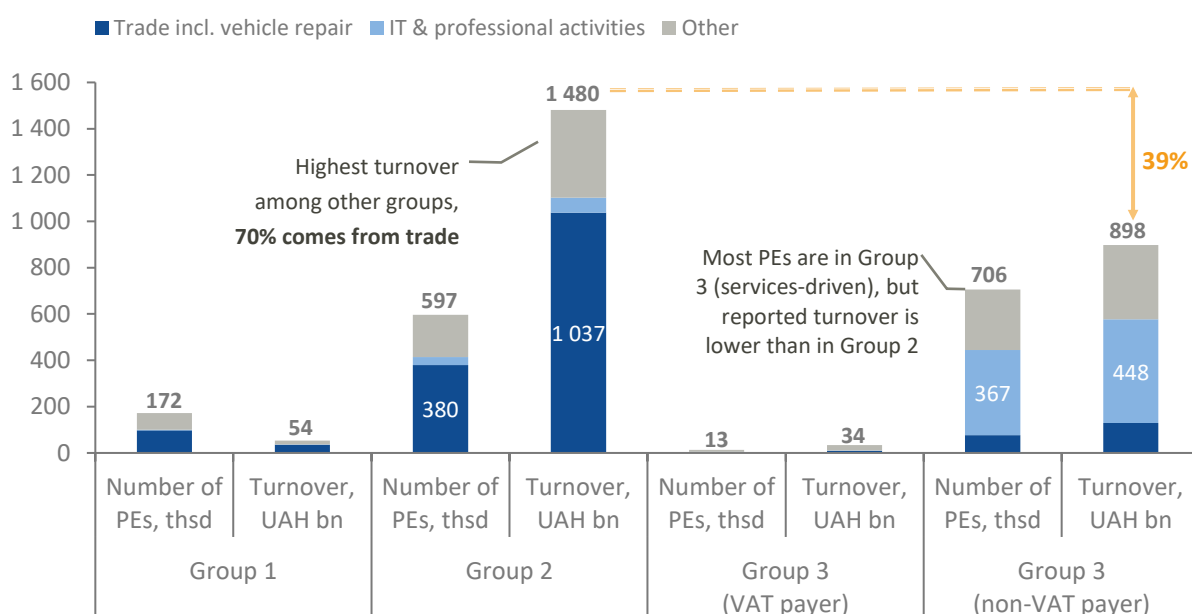
The STS has, in a significant part, evolved into a mechanism that enables shadow economic practices, although it was originally designed to provide space for early-stage businesses to become tax-compliant and grow. Private entrepreneurs (PEs) operating under the STS are predominantly non-VAT payers and are not required to document the origin of goods. While benefiting genuine small businesses, this framework has also created opportunities for larger or more economically significant market participants operating through STS arrangements to weaken transaction traceability, engage in markets involving undeclared, grey-imported, or otherwise illegal goods, and avoid salary-related taxes.

The implications of these features extend beyond individual taxpayers to the level of the economy as a whole. Operations of PEs under the STS generate total reported turnover of around UAH 2.5 tn in 2024 (~EUR 50 bn [Figure 1](#)). This scale underscores the broad scope of economic activity conducted under the STS, whose effects extend beyond the system itself to affect all segments of the economy. Ukraine's simplified tax system was designed as a step-by-step progression from micro businesses to fully

formalised small and medium-sized enterprises operating under the general tax system, allowing firms to gradually increase their scale, employment and compliance obligations as they grow. Group 1 covers microbusinesses with no employees and the lowest turnover cap (UAH 1.3 m, approximately EUR 26 thsd in 2024), paying a small fixed tax of under EUR 10 per month. Once a business outgrows this threshold, it must register under Group 2, which allows up to 10 employees and higher turnover of UAH 6.7 m (approximately EUR 135 thsd), taxed at a flat monthly rate of around EUR 25-30 per month. As a next step, Group 3 includes larger PEs (up to UAH 9.3 m, approximately EUR 186 thsd) and a number of activities ineligible under Group 2, including activities involving precious metals and stones and the provision of services to legal entities². It is split into VAT and non-VAT payers and taxed on turnover at rates of 3% or 5%. The general tax system, under which larger companies operate, applies profit taxation and social contributions, alongside full financial reporting requirements. VAT registration becomes mandatory once turnover exceeds UAH 1 m (approximately EUR 20 thsd) in 12 subsequent months. A detailed comparative overview of the STS groups and the general taxation regime, including tax rates, turnover ceilings, employment limits and VAT status, is provided in Annex A³.

Figure 1. STS is dominated by Group 2 (wholesale and retail trade) and Group 3 non-VAT payers (service activities, especially IT and professional services)

STS PE breakdown by number and turnover in 2024



Source: Own representation based on State Statistics Service (2026)⁴

Currently STS usage is highly concentrated in two segments, which together account for around half of all PEs under the STS. Approximately one quarter of total STS PEs operate in trade incl. vehicle repair and mostly use Group 2, where they pay fixed tax (up to UAH 1 600 in 2024) and are exempt from VAT. This segment generated 42% of total STS turnover in 2024. Another quarter consists of IT and other professionals using Group 3, who pay 5% of their income and are also VAT-exempt. The third notable

² As of 2026, Group 1 PEs pay a monthly unified tax of up to UAH 323 with an annual turnover threshold of UAH 1.4 m, while Group 2 PEs pay up to UAH 1,730 per month with a turnover threshold of UAH 7.2 m. Groups 3 turnover threshold amounts to UAH 10.1 m.

³ There is also a Group 4 for agricultural producers which is out of the scope for this paper.

⁴ This information is not publicly available and received upon request

segment (around 57%) are PEs under Group 1, who operate with a turnover up to UAH 1.2 m (around 12% of STS users) engaged in trade). The B2B activity is concentrated mainly in Group 3⁵.

In practice, this step-by-step organisation does not function as intended. Companies are trying to stay at the lower levels for as long as possible, using all kinds of available means. The system abuse and the need for its reform was long on top of the (sometimes heated) policy discussions (Gaidai et al. 2021), and is now anchored in Ukraine's Ministry of Finance (2023) National Revenue Strategy until 2030, Organisation for Economic Co-operation and Development (OECD, 2025a) policy recommendations, and the Staff-Level Agreement between the International Monetary Fund (IMF, 2026) and the Ukrainian authorities under the Extended Fund Facility, which emphasize reducing channels for shadow-economy activity and strengthening tax compliance. Reform should allow to retain competitive advantages for genuinely small entrepreneurs while ensuring they have incentives to grow rather than hold on to the STS at all costs – and to prevent medium and large businesses from using this regime as a tax-optimization tool.

2.2. Statistical evidence of the misuse and tax avoidance

One of the main statistical pieces of evidence of the STS misuse⁶ is that the revenue distribution of PEs does not correspond to the distribution observed for firms in the economy⁷. While economic fundamentals such as demand, productivity, and technology shape firm size, they do so in similar ways across legal forms, making large systematic deviations across regimes a strong signal of regulatory arbitrage rather than real economic differences.

In a standard setting, revenue distributions in economies are well approximated by a Pareto distribution (Jones, 2015) or log-normal distribution with a characteristic L-shaped form. As turnover increases, the number of firms naturally declines. Economic theory explains this trend by hierarchical organization and employees' skills (Geerolf, 2017).

This pattern is clearly observed among companies operating under the general taxation system, where the revenue distribution follows a smooth downward slope without abnormal concentration at specific turnover levels (Figure 2). The Kyiv region was selected for illustration purposes because it combines a high concentration of large formal enterprises under general taxation system, developed service and trade sectors, and the highest quality of administrative data, making it quite robust example of a typical firm revenue distribution. According to our calculations (Repko et al. 2025), Kyiv region generated 7% of Ukraine's GDP in 2024, which is the second-highest result among the country's regions. Deviations from this smooth, monotonic distribution - particularly the clustering of observations around specific turnover thresholds - cannot be explained by demand patterns, seasonality, or sectoral composition and are not characteristic of organic firm growth. They therefore typically reflect institutional or regulatory distortions, rather than underlying economic fundamentals.

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⁵ As the provision of services to legal entities is prohibited under Group 2.

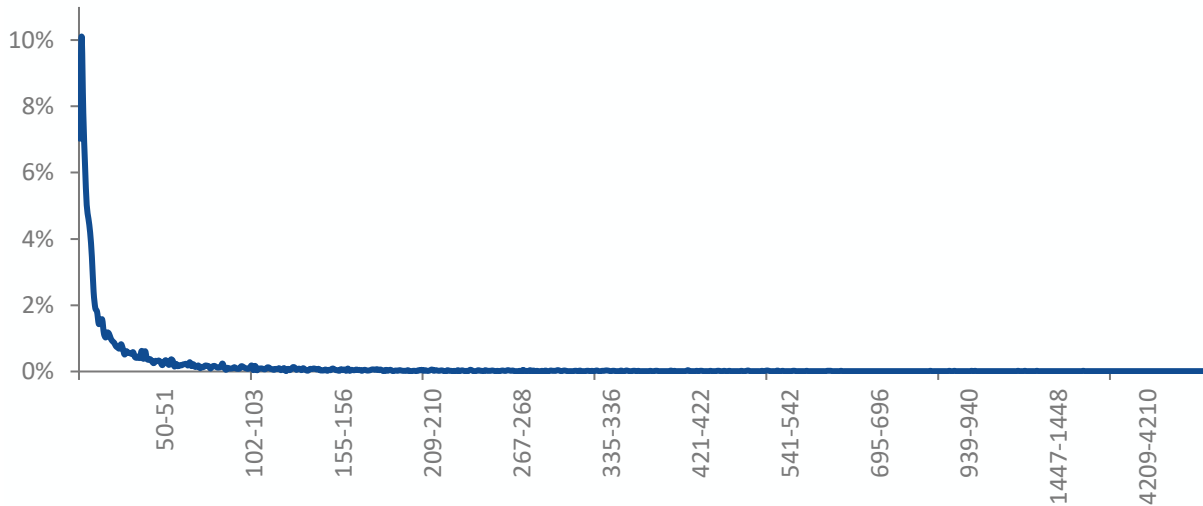
⁶ Based on OECD (1987), tax avoidance is the practice of artificial reducing tax liabilities by legally taking advantages of loopholes in the law or of applying legal provisions for purposes for which they were not intended.

⁷ We use for the analysis the same analytical framework as in our previous study (Gaidai et al. 2021).

this smooth, monotonic distribution - particularly the clustering of observations around specific turnover thresholds - cannot be explained by demand patterns, seasonality, or sectoral composition and are not characteristic of organic firm growth. They therefore typically reflect institutional or regulatory distortions, rather than underlying economic fundamentals.

Figure 2. The distribution of firm revenues under the general taxation system follows a Pareto distribution

Distribution of the number of companies in Kyiv Region by revenue in 2024, m UAH



Source: Own representation based on YouControl⁸ (2026)

The turnover distribution of PEs in Ukraine, by contrast, displays pronounced clustering around statutory thresholds, indicating systematic adjustments in reported activity to remain within the STS. Figures 3-6 demonstrate that such behaviour is not a marginal anomaly but an embedded feature of the system, observed across all PE groups and most pronounced in Group 2. Similar patterns are also evident in Annex B, which provides a breakdown of PE turnover by category.

Peaks around these artificial thresholds provide a quantitative basis for two distinct but related processes. “Splitting” and “multiplication” of PEs represent forms of tax avoidance, where businesses reorganise their legal structure to remain below statutory thresholds while continuing the same economic activity. Multiplication refers to the creation of multiple nominally independent PEs operating as a single coordinated economic unit, while splitting involves distributing turnover across several PEs to avoid crossing group limits. These practices exploit legal loopholes without necessarily breaking the law, but they distort competition and tax neutrality.

Second, these avoidance strategies create the infrastructure for tax evasion⁹, as fragmented STS structures operate without inventory accounting, VAT chains, or systematic transaction traceability. This allows the circulation of smuggled, counterfeit, or undeclared goods, and the use of fictitious tax documentation, which directly violates tax and customs law. Scaling these processes has created a segment of the STS economy in which some PEs operate at a scale and organisational complexity comparable to firms in the general taxation system, but with far weaker regulatory oversight. Businesses operating through networks of private entrepreneurs cannot produce consolidated financial statements and therefore have limited access to bank financing and institutional investors. Investment is financed

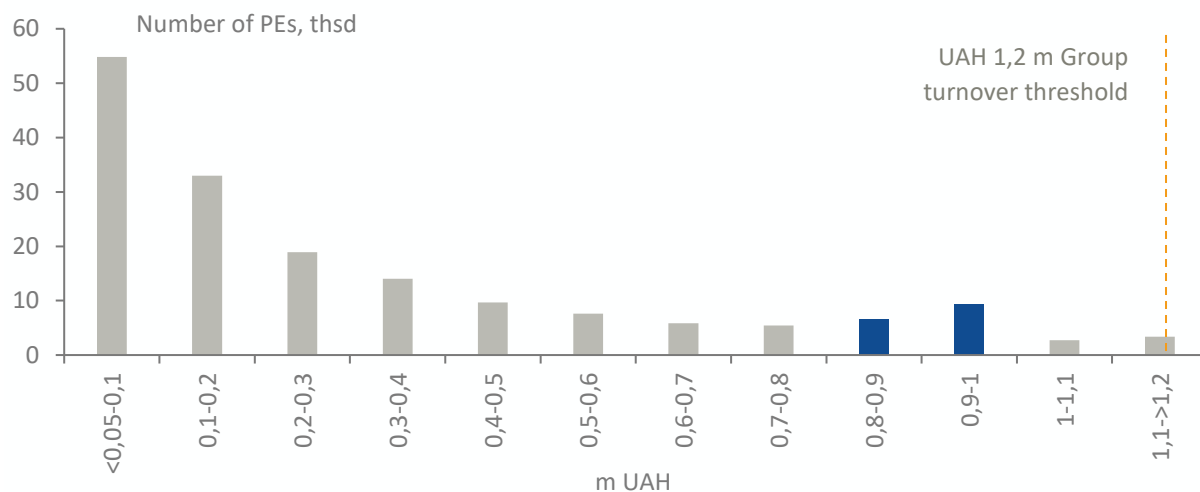
⁸ This information is not publicly available and was received under subscription.

⁹ Based on OECD (1987), tax evasion is an action by the taxpayer which entails breaking the law and which moreover can be shown to have been taken with the intention of escaping payment of tax.

mainly through retained earnings or informal sources, constraining growth, and weakening corporate governance.

Figure 3. In Group 1, minor clustering appears around the UAH 1 m turnover threshold (previously served as the cash register (RRO) threshold)

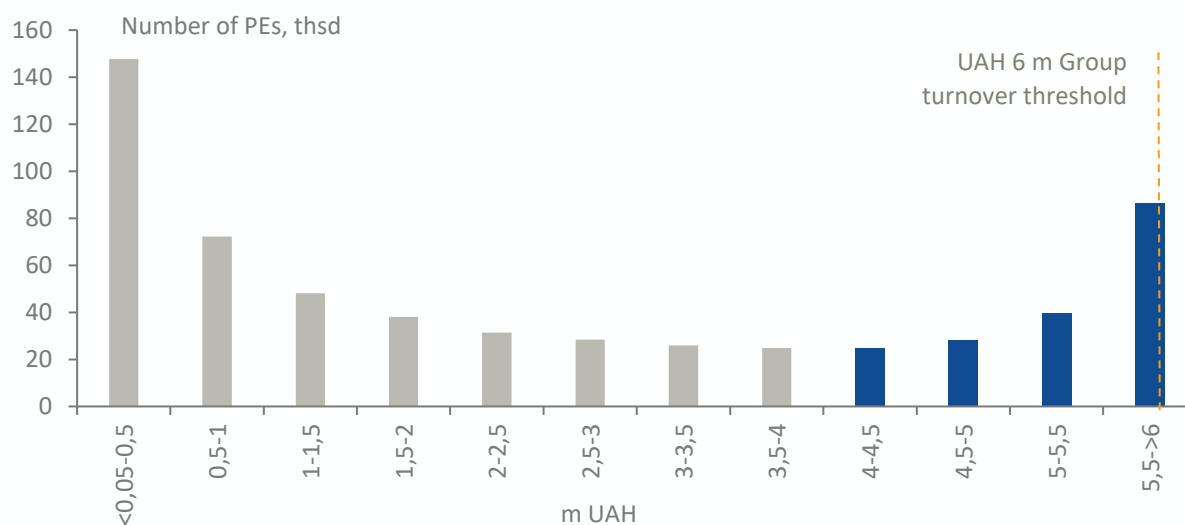
Distribution of the number of Group 1 PEs by turnover in 2024, m UAH



Source: Own representation based on State Statistics Service (2026), own estimate

Figure 4. In Group 2, clustering begins at turnover levels of UAH 4-4.5 m

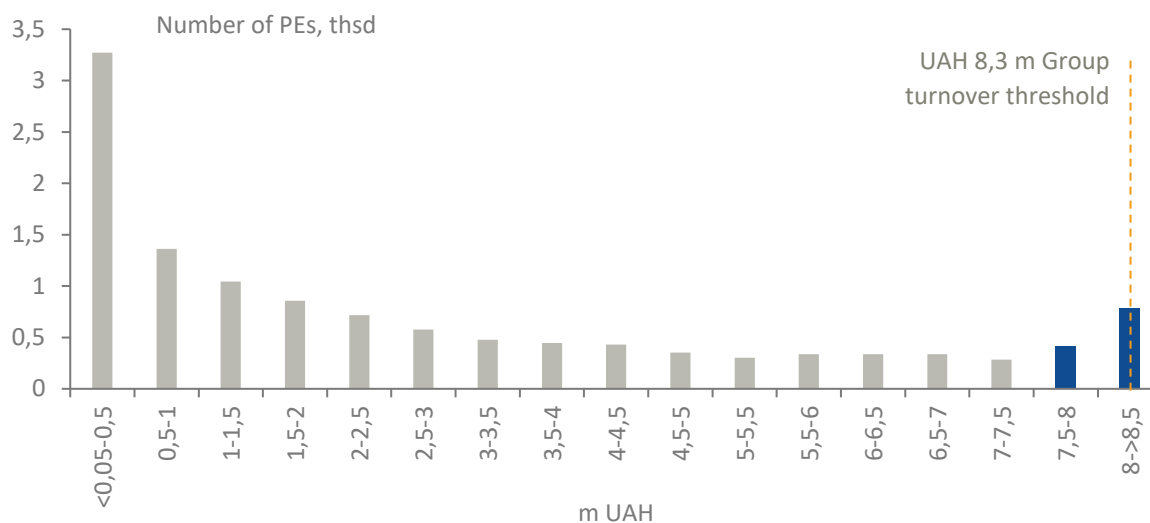
Distribution of the number of Group 2 PEs by turnover in 2024, m UAH



Source: Own representation based on State Statistics Service (2026), own estimate

Figure 5. In Group 3 (VAT-payers), clustering begins at turnover levels of UAH 7.5-8 m

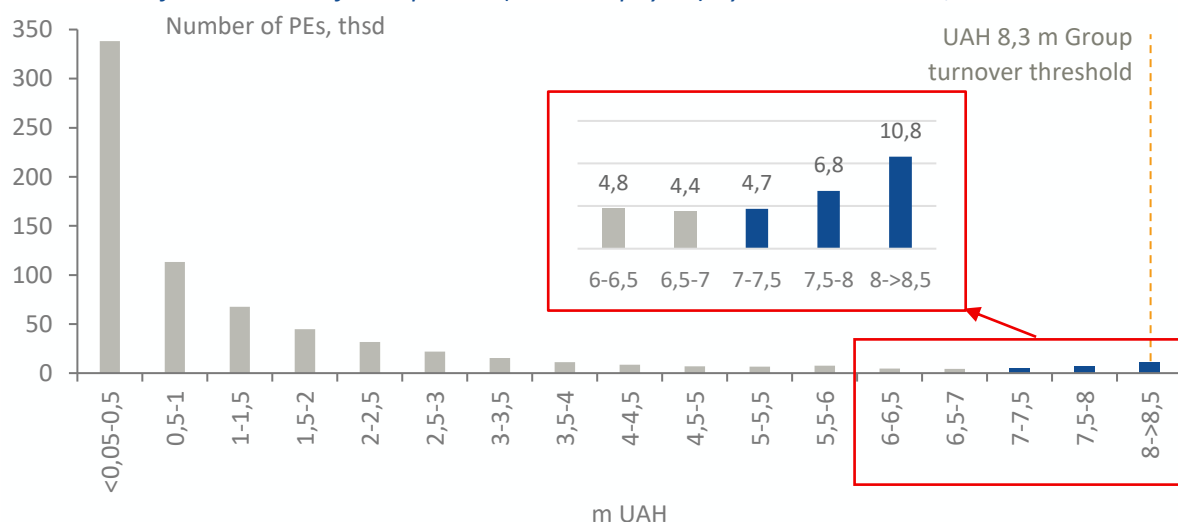
Distribution of the number of Group 3 PEs (VAT payers) by turnover in 2024, m UAH



Source: Own representation based on State Statistics Service (2026), own estimate

Figure 6. In Group 3 (non-VAT payers) clustering begins at turnover levels of UAH 7-7.5 m

Distribution of the number of Group 3 PEs (non-VAT payers) by turnover in 2024, m UAH

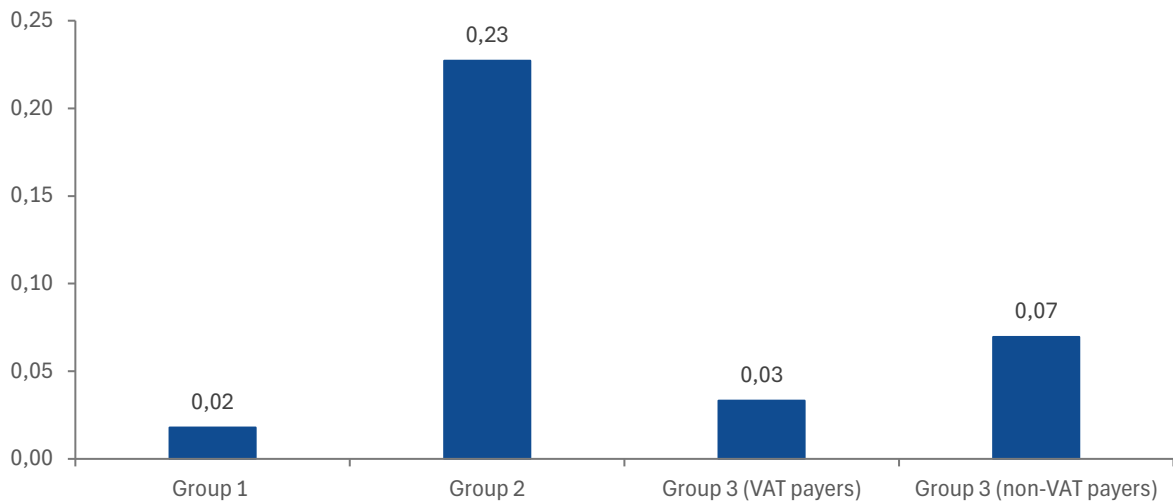


Source: Own representation based on State Statistics Service (2026), own estimate

The splitting under the STS is most pronounced among Group 2 PEs, followed by Group 3 non-VAT payers (Figure 7Figure 7), as indicated by the intensity of clustering around statutory thresholds. The methodology used to calculate the splitting index¹⁰ follows our earlier study (Gaidai et al. 2021), and measures deviations from the expected Pareto-type turnover distribution, capturing the extent of bunching just below regulatory cut-offs.

¹⁰ A higher index indicates a stronger likelihood of potential system abuse. To calculate the Splitting Index, we analyzed turnover distributions by sector, identifying the point where the natural decline in the number of PEs breaks and an abnormal increase begins, using the last “healthy” point as a reference. The gap between this expected level and the actual distribution indicates the scale of the anomaly, which is then related to total sector turnover to produce the Splitting Index for each sector within the group.

Figure 7. The highest concentration of potential misuse is observed in Group 2, where a unified tax amounts to UAH 1,420 per month
Splitting index by PE groups in 2024

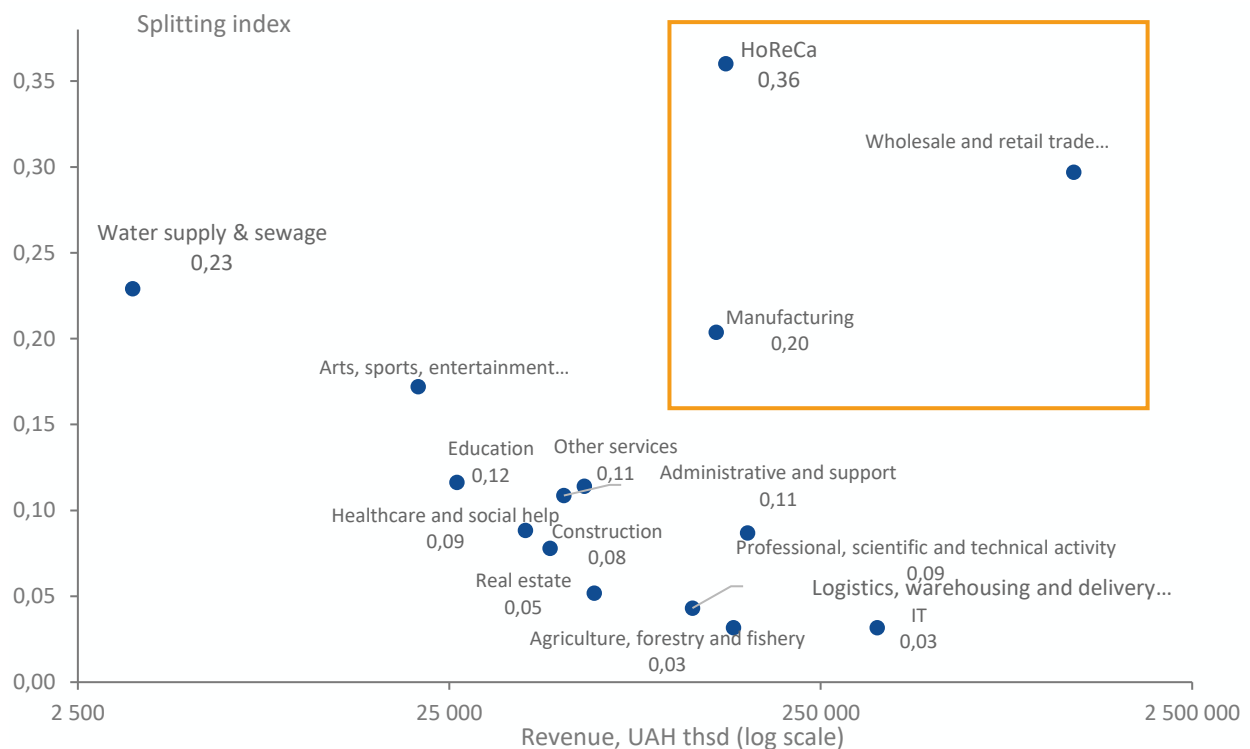


Source: Own representation based on State Statistics Service (2026), own estimate

The main drivers of potential abuse are concentrated in the HoReCa, wholesale and retail trade, and manufacturing sectors, which combine high turnover volumes with high abuse indices (Figure 8). Most PEs exhibiting signs of business fragmentation in these sectors are concentrated in Group 2, benefiting from minimal taxation.

Figure 8. High splitting index and high sectoral turnover are concentrated in HoReCa, wholesale and retail trade, and manufacturing sectors

Top economic activities by turnover and splitting index within STS groups in 2024

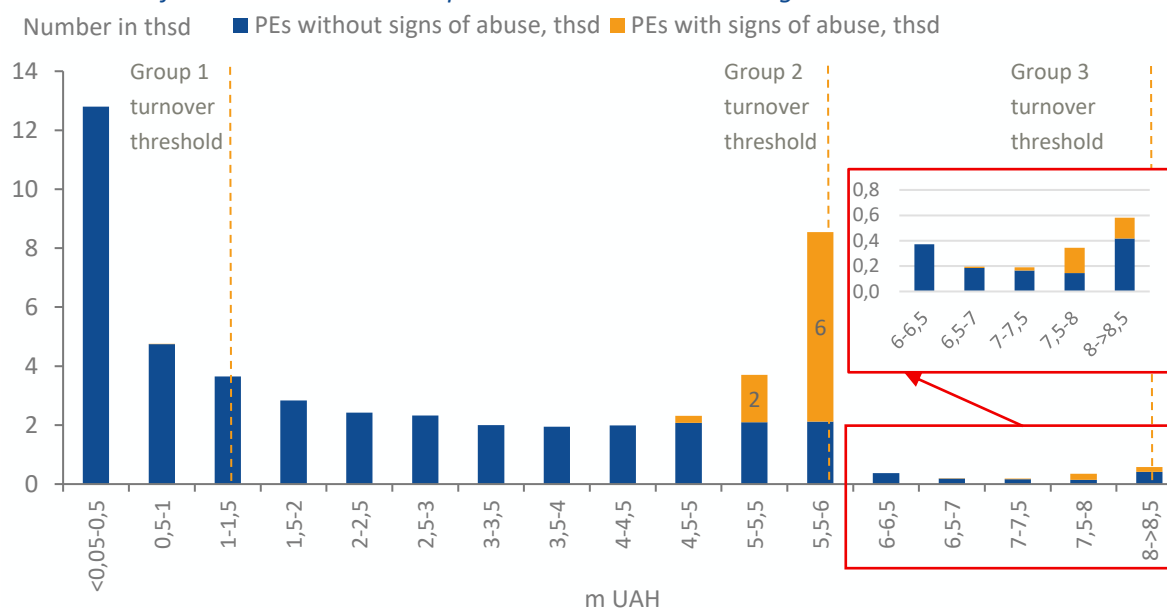


Source: Own representation based on State Statistics Service (2026), own estimate

As illustrated in the Figure 9 Figure 9-11 below, the distribution observed in these sectors shows that near turnover thresholds, a distinct business layer emerges. While each PE individually appears “small,” with an annual turnover of around UAH 4-6 m and paying the unified tax of UAH 1,420, these modular networks effectively operate at a scale comparable to large companies, with dozens or even hundreds of interconnected PEs replicating the same structure.

Figure 9. In HoReCa, around 5 TH PEs show signs of misuse and may potentially generate UAH 50 bn in turnover (35% of total sectoral turnover)

Distribution of PEs in HoReCa: Pareto pattern and excess clustering around thresholds



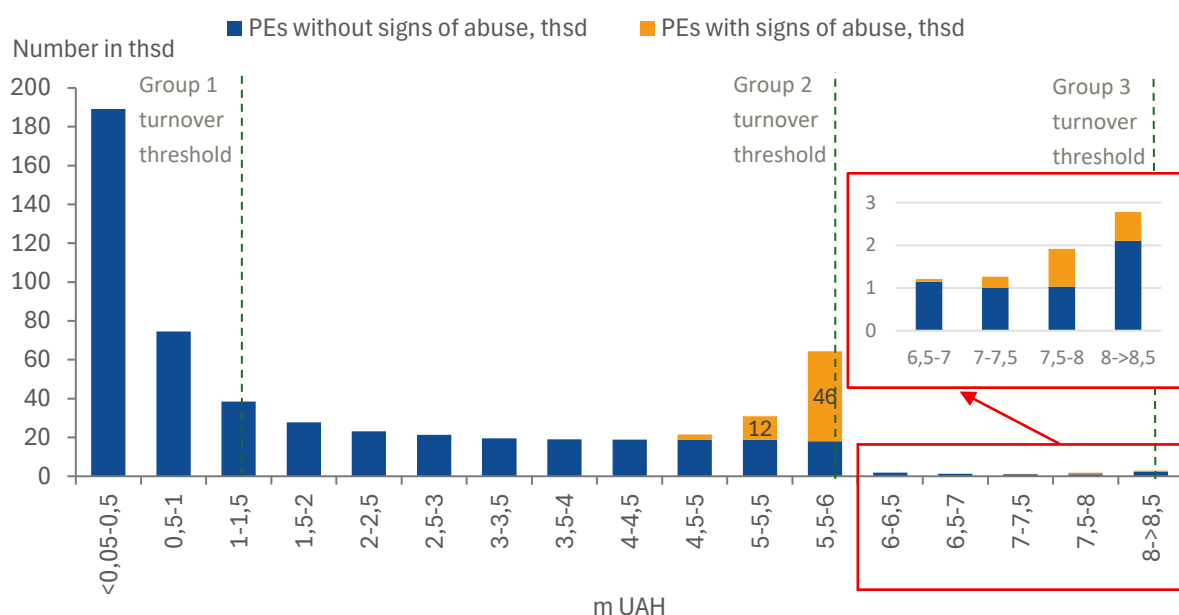
Source: Own representation based on State Statistics Service (2026), own estimate

This structural setup enables both legal and illegal distortions. Retail, electronics, and HoReCa businesses operating through networks of PEs can avoid VAT and profit taxation through artificial fragmentation, while at the same time selling goods of undocumented or illegal origin. By operating outside the VAT system and without mandatory inventory accounting or invoice matching, fragmented STS networks create supply chains in which the origin of goods cannot be verified, making them an ideal

channel for smuggled and undeclared products. This has been repeatedly confirmed by enforcement actions.

Figure 10. In retail and wholesale trade, around 63 TH PEs show signs of misuse and may potentially generate UAH 356 bn in turnover (29% of total sectoral turnover)

Distribution of PEs in trade (incl. vehicles): Pareto pattern and excess clustering around thresholds

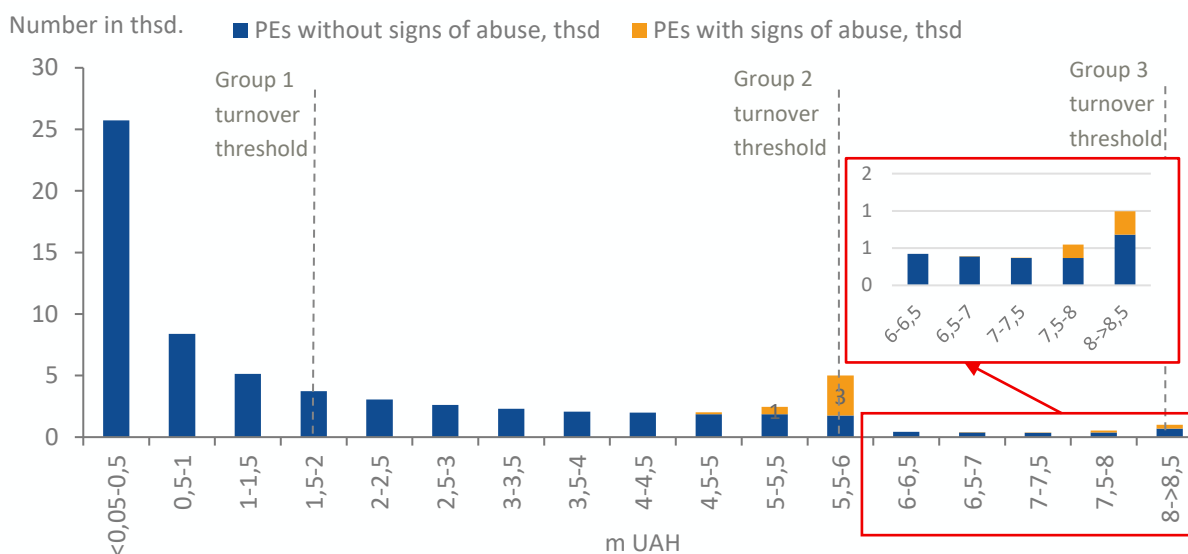


Source: Own representation based on State Statistics Service (2026), own estimate

One of the most popular tax evasion schemes in Ukraine involves dividing companies into individual entrepreneurs, who utilize the STS to avoid paying VAT, profit tax, and personal income tax. According to Danylo Hetmantsev (MinFin Media, 2025), Head of the Parliamentary Committee on finance, tax, and customs policy, companies in the retail, hotel, and restaurant industries use this scheme. Such activities are carried out without inventory accounting, which enables the sale of smuggled goods or goods illegally manufactured in Ukraine. Last year, the State Tax Service (2025a) exposed a scheme of “business fragmentation” in two well-known electronics retailers, which evaded paying VAT of over UAH 286 m (State Tax Service, 2025b). In July 2025, the Prosecutor’s General Office (2024) reported a similar situation, where gadgets of well-known brands were illegally shipped to and were intended to be sold in Ukraine using more than 100 controlled individual entrepreneurs to minimize tax liabilities. In July 2025, the State Tax Service (2025a) identified 7 retailers for using the same scheme. The budget incurred a loss of UAH 668.5 m in VAT due to its use. One of the factors that enables smuggled products to reach the Ukrainian market is customs abuse. For example, according to the Parliamentary Temporary Investigation Commission (Verkhovna Rada, 2025a), illegal import of flowers over the past 3.5 years led to a budget loss of more than UAH 600 m. These flows are subsequently distributed through fragmented STS-based retail networks, where neither VAT chains nor inventory controls exist. Another illegal scheme of VAT abuse is a conversion center, which registers fictitious tax invoices, so other companies can evade paying VAT. One of such conversion centers was exposed by the National Anti-Corruption Bureau of Ukraine (NABU, 2025). The effectiveness of such schemes is significantly increased when final-stage retail and distribution are conducted through STS PEs operating outside the VAT system. Together, the statistical evidence of bunching and sectoral abuse, combined with enforcement cases, demonstrates that the STS has become not only a channel for tax avoidance but also a structural enabler of tax evasion and shadow trade.

Figure 11. In manufacturing, around 5 TH PEs show signs of abuse and may potentially generate UAH 27 bn in turnover (20% of total sectoral turnover)

Distribution of PEs in manufacturing: Pareto pattern and excess clustering around thresholds



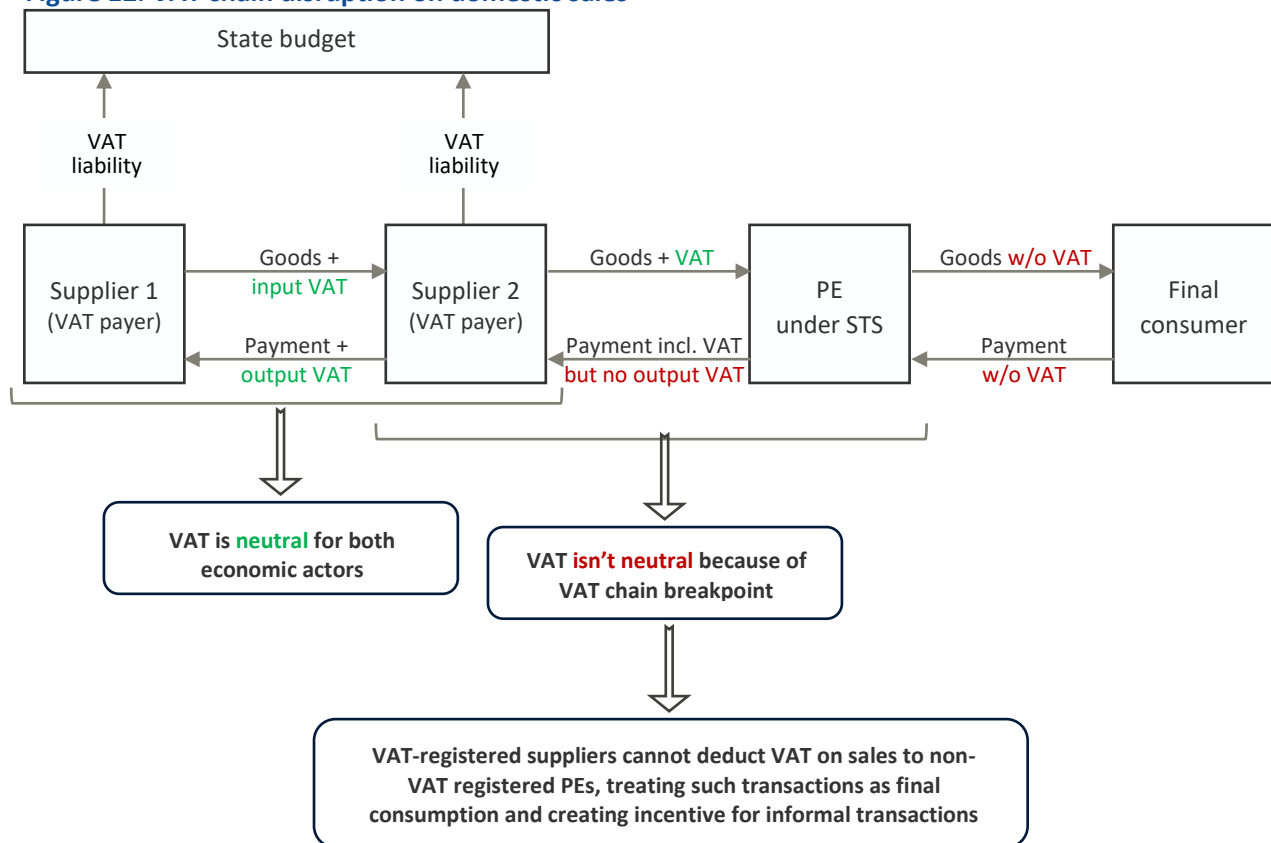
Source: Own representation based on State Statistics Service (2026), own estimate

2.3. STS impact on economic agents' behaviour and tax evasion

Although the STS was introduced as a transitional regime – combining tax relief with simplified administration to help small businesses gradually enter the general tax system – in practice it has evolved into a framework that firms seek to remain in rather than grow out of. This outcome follows directly from the institutional design of the STS. Lower effective tax rates, exemption from VAT and simplified accounting make it financially more attractive to preserve small scale status than to expand within the general tax regime. These incentives generate widespread artificial business fragmentation, as described in 2.2. Similar incentives exist in Group 3, where employment relationships in professional services and IT are frequently reclassified as self-employment.

VAT exemption plays a central role that enables shadow economic practices. Under Article 185.1 of the Tax Code of Ukraine, VAT applies to the supply of goods and services regardless of the status of the buyer, and Article 194.1.1 requires VAT to be included in the transaction price. As a result, private entrepreneurs under the STS, even when they are not registered for VAT, pay VAT embedded in the prices of goods and services purchased from VAT registered suppliers. At the same time, Article 297.1 exempts STS taxpayers from charging VAT on their own sales and denies them the right to deduct input VAT. Within the invoice credit VAT system, STS entrepreneurs therefore operate as non-deductible buyers, even though economically they remain part of business supply chains. In a standard international VAT system, supplies to such buyers should result in VAT being effectively collected at that stage, with the supplier remitting output VAT net of its own input VAT. This outcome depends on the tax invoice mechanism. Under Article 201.10 of the Tax Code, every taxable supply by a VAT registered seller must be recorded through a tax invoice, allowing cross-checking and traceability of goods. When the buyer is an STS entrepreneur who is not registered for VAT, this mechanism breaks down. The buyer has no right to deduct VAT and therefore no incentive to request a tax invoice. As a result, transactions with such buyers become points where invoice-based traceability ends (Figure 12).

Figure 12. VAT chain disruption on domestic sales

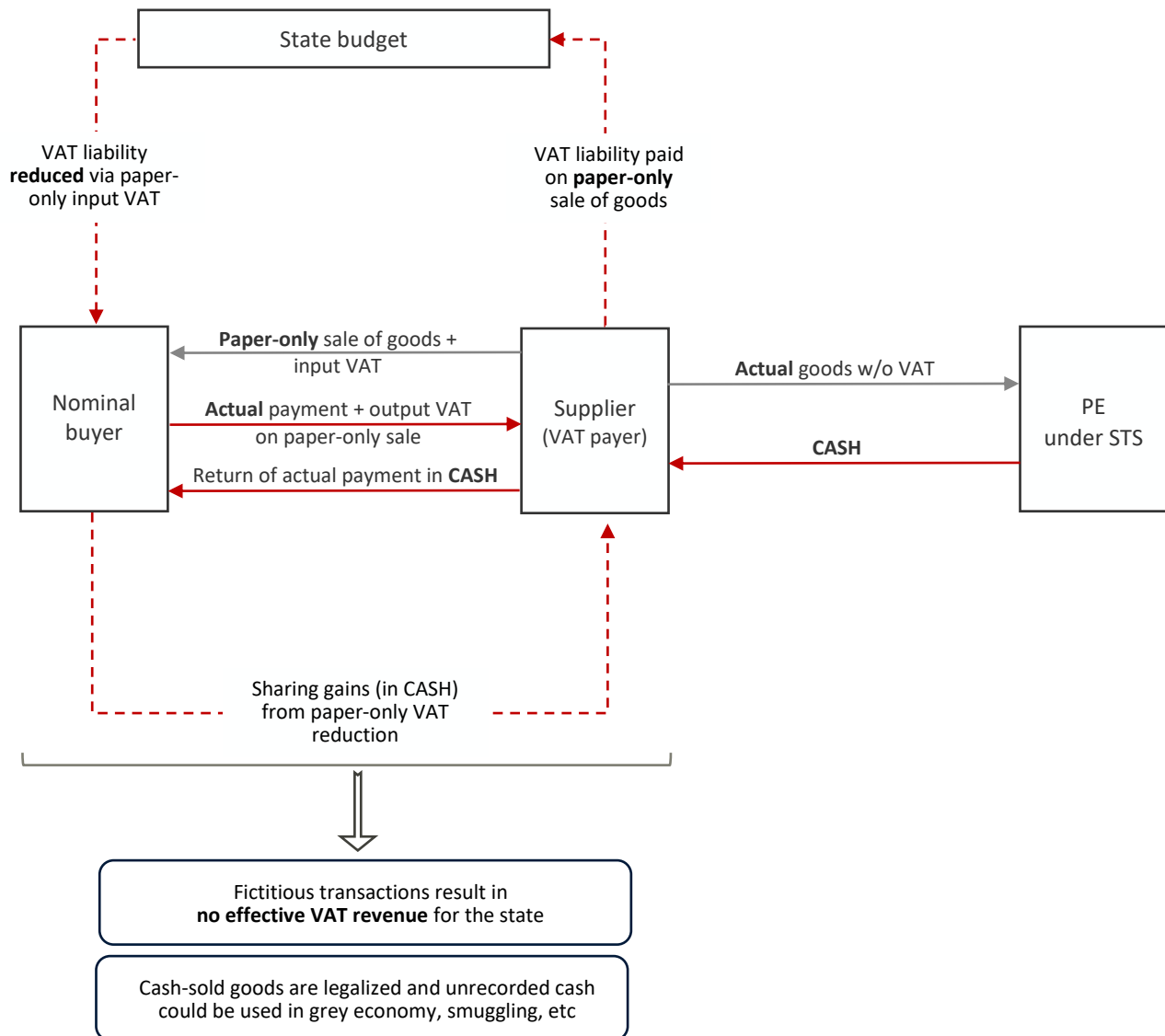


Source: own representation based on Tax Code of Ukraine (Verkhovna Rada, 2019)

For VAT registered suppliers, a fully recorded sale to such a buyer implies declaring output VAT net of their input VAT. In practice, this creates incentives for tax evasion, such as selling off the books, typically in cash, and avoiding declaring output VAT. The physical goods then enter retail and service networks operating under the STS and are sold to final consumers.

The VAT that should have been collected at the retail stage is instead “neutralized” through chains of technical or fictitious VAT payers. Artificial input VAT credits are generated and used to offset declared output VAT. Formally the VAT accounts balance, but no revenue reaches the budget (Figure 13). Cash based transactions reinforce this model. STS entrepreneurs face limited inventory control, can easily convert business receipts into personal cash, and report turnover only periodically. Simplified reporting does not link purchases, inventories, and sales, allowing undeclared goods and revenues to circulate with limited tax visibility.

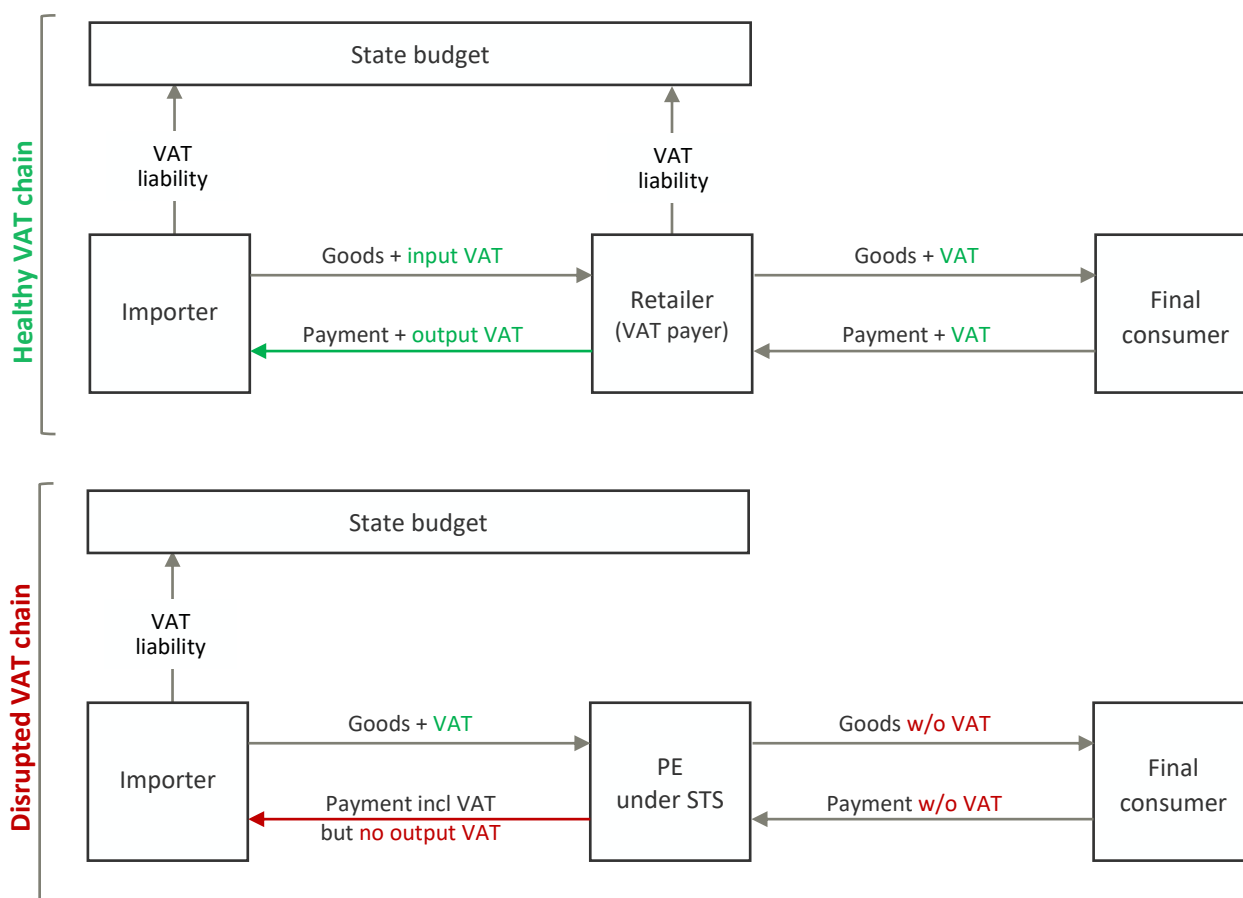
Figure 13. Consequences of VAT chain disruption: fictitious transactions and cash leakage



Source: own representation based on Tax Code of Ukraine

Import VAT is paid upfront, but its neutrality depends on the continuity of the VAT chain after customs clearance. When imported goods remain within the VAT system, the tax functions as intended. Once goods are channelled to non-VAT registered PEs under the STS, VAT ceases to be neutral and turns into a cost, reshaping incentives along the supply chain.

Figure 14. VAT chain between importer, VAT-registered actors & PE under STS in import transactions



Source: own representation based on Tax Code of Ukraine (Verkhovna Rada, 2019)

3. Design and Impact of VAT Reform

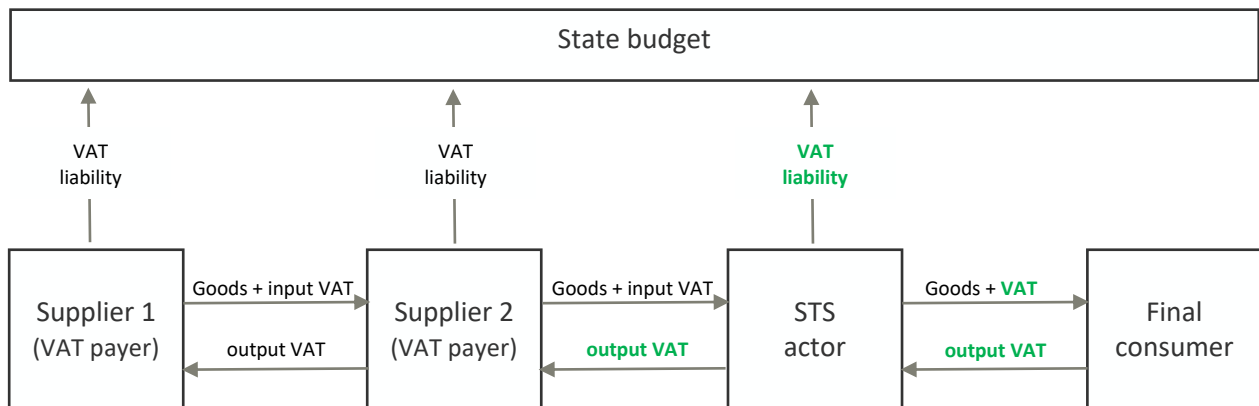
3.1 VAT reform proposal

Within the framework of the IMF–Ukraine Extended Fund Facility (EFF), one of the agreed prior actions is the removal of the exemption from the general VAT registration rule for taxpayers operating under the STS. This entails repealing the special exemption in Article 181.1 of the Tax Code of Ukraine and applying a single mandatory VAT registration threshold to all economic operators, regardless of the tax regime they use. This approach is also consistent with Ukraine’s National Revenue Strategy to 2030, which aims to broaden the tax base by removing system-based distortions and integrating economic activity into unified tax chains.

The proposal to remove the VAT exemption stems from the STS’s structural design, which inherently incentivizes businesses to remain in the system beyond its intended scope (as described in 2.2), while current enforcement mechanisms address only the resulting abuses rather than eliminating the root cause. Currently, the measures available to address VAT abuses under the STS are limited to the analytical work of the State Tax Service, which identifies potential violations through the analysis of locations, counterparties, financial flows, supported by factual and documentary inspections, as well as the financial monitoring system that oversees transactions with the ability to limit bank account

servicing in cases of any risks¹¹. The Economic Security Bureau (BEB) intervenes when STS activity indicates potential criminal conduct, such as tax evasion, smuggling, or fictitious entrepreneurship. The VAT reform proposal aims to restore the core logic of VAT as a neutral tax on value added by closing gaps in the VAT chain currently exploited in sectors with high concentrations of PE abuses, while simultaneously promoting fairness and reducing competitive distortions between STS and general system participants, yet preserving STS benefits to maintain competitiveness for PEs. This restores the basic logic of VAT as a neutral tax on value added and makes PEs full participants in the VAT chain (Figure 15).

Figure 15. VAT chain restoration: neutral taxation on value added



Source: own representation based on Tax Code of Ukraine (Verkhovna Rada, 2019)

The reform leaves the treatment of small-scale activity below the VAT threshold unchanged. Transactions between non-VAT entrepreneurs below the threshold remain outside the VAT system. Where a private entrepreneur purchases goods or services from a VAT-registered supplier, VAT is already included in the price under current law.

The practical impact of VAT registration differs across business models, depending on whether a firm supplies goods or services and whether it operates in domestic markets, exports, or imports. These differences are analysed in details in Section 3.3. The measure is scheduled to enter into force on 1 January 2027, providing a sufficient transition period for compliance preparation. During this period, the authorities should conduct taxpayer outreach, roll out simplified electronic invoicing and reporting tools, and apply a risk-based approach to VAT enforcement, so that STS taxpayers are integrated into the VAT system without disproportionate administrative burdens while achieving a rapid reduction in shadow-economy activity. While introducing VAT for STS actors is a complex and politically sensitive measure, it represents a balanced approach compared to other potential options, which are either less effective or entail even greater implementation challenges:

- Reducing turnover thresholds for STS groups could improve detection of abuses and make large networks of PEs more visible to authorities. However, it carries risks for genuine microbusinesses, which may not be ready for the general taxation system, potentially pushing some activity into the shadow economy and reducing overall economic activity.
- Expanding the list of prohibited activities for STS, such as trade and HoReCa sectors, would remove tax competitive advantages in STS and limit gray schemes, yet this approach risks raising barriers for small businesses, encouraging market concentration, and driving further shadow activity.

¹¹ Tax inspections have measures re-declaring fake entrepreneurship to employment with massive consequences at companies which „purchase“ at FOP „services“ which are in fact employment.

- Allowing voluntary VAT registration for all simplified groups provides incentives for formalization and benefits B2B transactions and exporters, but it does not solve the root causes of abuses on its own, e.g. comparing number of PEs in Group 3 VAT payers and in Group 3 non-VAT payers.
- Restricting cash withdrawals by PEs (where each withdrawal is treated as taxable income or subject to a transaction fee) can reduce the appeal of off-the-books transactions and improve transparency, yet as a standalone measure it is risky. It may create new circumvention schemes, disproportionately affect small PEs, and encourage avoidance of the banking system.
- Raising unified tax rates, even with sectoral differentiation, may close some gaps with labor taxation and is relatively straightforward to implement. However, it does not restore the VAT chain or prevent the incentives for business fragmentation inherent in the simplified system.
- Maintaining the status quo is politically low-risk and avoids short-term shocks, but it locks in existing abuses and distortions in competition and deepens informal transactions.
- Granting the tax authority access to daily banking transactions could significantly improve real-time monitoring of cash flows and help detect potential abuses more effectively than quarterly or annual declarations. However, current institutional capacity, legal constraints, and trust issues make this option very difficult to implement, and it remains politically and operationally sensitive.

3.2 The EU practice of VAT for SME actors

3.2.1 The development of VAT regulations in the EU and their current design

Over the last decades, the EU has made great progress on VAT registration threshold regulation. In 1977, the Sixth VAT Directive of the EU (77/388/EEC) allowed Member States to exempt SMEs from paying VAT. Since this Directive didn't set any specific VAT registration thresholds, countries had the complete freedom to set their own ones.

From 1980 to 2007, 18 countries to the EU. The EU established an asymmetric, accession-specific VAT registration threshold ceiling regarding each of the new Member States. Consequently, each country received a limit up to which they may exempt small businesses from VAT. Those ceilings ranged from EUR 10 000 to EUR 37 000 (Annacordia & Van der Corput, 2009). For example, Poland was provided with a ceiling of EUR 10 000 (zł 45,300), although it previously had a higher limit of 80,000 zł in 1999 (Lenain and Bartoszek, 2000). Council Directive 2006/112/EC (EU, 2006) systematized existing VAT rules into a single legal framework, replacing the Sixth VAT Directive and its numerous amendments. The Directive described the SME exemption scheme but didn't set any specific thresholds. The Directive (EU, 2020) 2020/285 shifted the policy regarding the VAT registration threshold. It introduced, for the first time, an EU-wide cap of EUR 85 000 for national SME VAT exemption thresholds. Furthermore, the Directive established a cross-border SME scheme, which simplified intra-EU trade. SME may be exempted from VAT payment in another Member State if their annual EU-wide turnover is less than EUR 100 000 and they do not exceed domestic limits in the countries of operation. As a result, this decision reduced complexity and burden of VAT administration. The introduction of the cross-border SME scheme enabled trading with multiple EU Member States without registering as a VAT payer in each country of operations, provided the business adhered to national thresholds. The current maximum of the national VAT registration threshold in EU countries is EUR 85 000 (approx. UAH 4.2 m, lower than the Groups 2 and 3 turnover threshold). It can be even lower in the nation states by their choice, but it cannot be higher than that. 2 Member States apply a zero VAT registration threshold, meaning that any taxable economic activity triggers a VAT registration obligation. 3 Member States apply a maximum permitted VAT registration threshold of EUR 85 000. The rest of the EU Member States set their national thresholds within this range. The detailed description is presented in the Annex D, Table D1. Countries

designing VAT policies face a fundamental challenge (Brockmeyer et al. 2024): balancing effective tax collection and economic neutrality with the administrative burden imposed on micro and small businesses. The mandatory VAT registration threshold is a key instrument for achieving this balance.

If a business exceeds the established threshold, it loses its right to VAT exemption. The Directive establishes a common VAT system, and Member States are not entitled to make arbitrary exceptions for individual businesses under the simplified tax system unless they fall under the conditions directly permitted by the Directive or specifically authorized by the EU Council. Member States have the possibility (European Commission, 2026) to set more than one national annual threshold. These are called sectoral thresholds. In case a small enterprise can benefit from more than one sectoral threshold, the tax authorities will, based on its activities, inform the small enterprise about the threshold to use since only one threshold can be applied per taxable person. Also, the VAT registration threshold may vary for different types of activities, e.g., for goods and services. For example, France and Ireland utilize two different VAT registration thresholds for goods and services, with a higher one for goods. The country's VAT registration threshold policy should be carefully devised, as increasing it is relatively easy to implement, but decreasing it is a politically complex decision due to its unpopularity. For example, France's parliament blocked a proposal to cut the VAT registration thresholds from 1 January 2026 in the blocked 2026 Budget (Caragher, 2026). The United Kingdom, not an EU member, has a high threshold of £90 000, which creates economic distortions (Mengden, 2025).

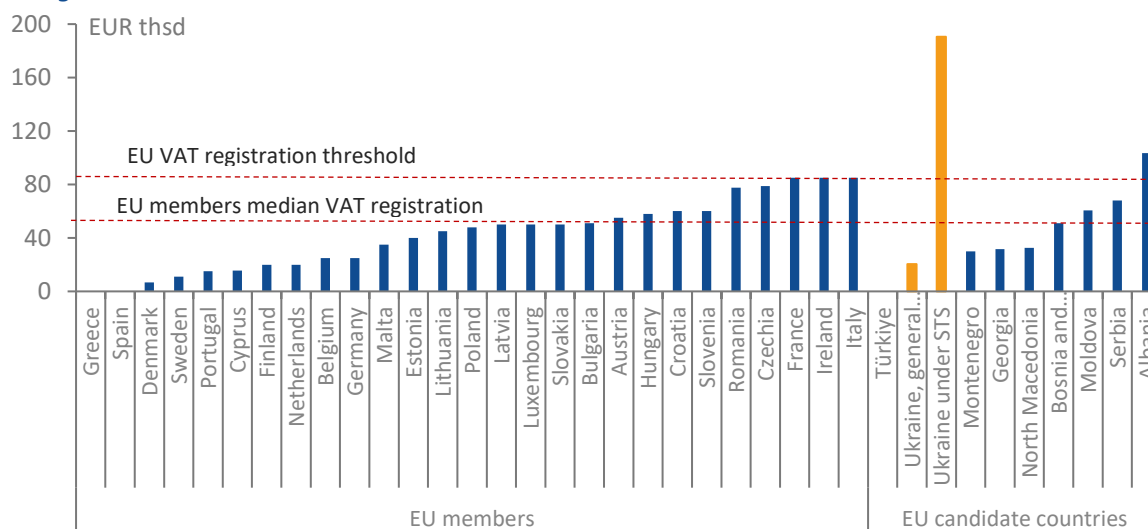
3.2.2 The key differences between Ukraine's and the EU's VAT policy and the required reforms

Since VAT rules must be based on objective characteristics of transactions, EU VAT rules establish a single criterion for distinguishing the STS from the general one - company turnover. Ukraine, in contrast, has two determinants: the entity's legal form and turnover. Consequently, two VAT registration thresholds exist in the country. The first one is EUR 20 000, which applies to the general taxation system (entities registered as companies), while the second one is EUR 186 000¹² set for entities registered as PEs under STS in 2024. Ukraine's current VAT policy design contradicts several of the EU's VAT rules principles. Firstly, the Ukrainian VAT policy sets two different thresholds based on the entity's legal form, whereas the EU has a single threshold for all economic agents. Secondly, the main criteria used in Ukraine is the entity's legal form, while the EU utilizes a company's turnover as a core criteria. The current high VAT registration threshold incentivizes businesses to exploit the STS for tax optimization purposes. To fulfil its true objectives of reducing tax administration burden for entrepreneurs, the Ukrainian VAT rules should be reformed. [Table 1](#) presents a comparison of VAT administration in Ukraine and Poland. A complete transition to a European VAT system requires the implementation of several unpopular changes. For example, granting the Tax Service access to bank transactions on business accounts, as is the case in Poland. The Polish control over VAT compliance is designed in the following way. Firstly, the National Revenue Administration has automatic daily access to the bank accounts of VAT payers. The Ukrainian Tax Service, on the other hand, doesn't have such access. Therefore, it controls bank transactions. Secondly, in the event of identified fraudulent activity, the National Revenue Administration blocks the account for up to 72 hours. In Ukraine, the invoice is blocked for up to 10 business days, but in practice it can take several months.

¹² As of 2026, the maximum thresholds for PEs under STS amounts to EUR 200 thsd

Figure 16. The STS VAT exemption introduces a dual VAT threshold in Ukraine, where the STS threshold significantly exceeds EU VAT thresholds

VAT registration threshold in EU vs in Ukraine



Source: Own representation based on European Commission (2026), own analysis

Table 1. Comparison of VAT Administration: Ukraine and Poland

Criterion	Ukraine	Poland
Primary object of control	VAT invoice (individual transaction-level control)	Taxpayer bank accounts and cash flows
Key enforcement instrument	Unified Register of Tax Invoices (URTI) and Automated VAT Risk Monitoring System (SMKOR)	STIR - bank transaction monitoring and analysis system
Point of intervention	At the moment of VAT invoice submission	At the stage of financial transaction analysis
Measure applied	Blocking of VAT invoice registration	Blocking of the taxpayer's bank account
Decision-making authority	State Tax Service (automated system and discretionary commission)	Head of the National Revenue Administration (SzeF KAS)
Legal basis for intervention	Formal risk indicators associated with a specific VAT invoice	Risk of the bank account being used for tax fraud or avoidance schemes
Initial duration of the measure	Until review of taxpayer explanations (up to 10 working days)	Up to 72 hours
Possibility of extension	Yes, pending commission or court decision	Yes, up to 3 months
Impact on the buyer	Input VAT credit unavailable until invoice is unblocked	Input VAT credit remains unaffected
Impact on the seller	VAT liability already arises and must be paid	VAT liabilities remain unchanged
Immediate financial effect	Temporary cash flow pressure due to blocked input VAT	Temporary restriction of access to bank funds
Access to banking data	Limited, primarily through court procedures	Automatic and continuous (daily access)
Treatment of input VAT credit	De facto conditional on invoice registration	Arises simultaneously with the seller's VAT liability

Source: own representation based on Verkhovna Rada (2010): Tax Code of Ukraine, Tax Code of Poland, Resolution of the Cabinet of Ministers of Ukraine (2019)

Ukrainian entrepreneurs currently face the challenge of having their tax invoices blocked. Centre for Economic Strategy, together with the National Agency on Corruption Prevention, collaborated on the development of the tax section of the Anti-Corruption Strategy 2030. It led to a proposal of a number of important reforms to reduce administrative discretion in the matter of blocking invoices. Proposed solutions (Verkhovna Rada, 2023) include specification of criteria for assessing the riskiness of taxpayers and transactions, including the definition of clear indicators, threshold values, and parameters for their application, as well as establishing the obligation to record the responsible officials for making decisions within the automated monitoring system for compliance with tax invoices or adjustment calculations with risk assessment criteria, among others.

Portugal prioritized digitalization over expanding direct access to state authorities. In particular, all VAT-registered businesses, including non-residents, are required to transmit invoice data (VAT Update 2025) electronically to the tax authority for all domestic and cross-border transactions through certified invoicing software using the SAF-T system. This approach enabled the introduction of pre-filled VAT returns for certain eligible businesses, as the tax authority uses transaction data already reported via SAF-T to generate draft VAT returns for each reporting period. At the same time, Portuguese state authorities have limited access to taxpayers' bank accounts. Such access to banking information and documents is subject to a specific administrative procedure (Matos & Freitas, 2019) and does not require prior court authorization. Overall, the Portuguese example highlights how digitalization can enhance transparency while simplifying VAT administration. The World Bank (2025) emphasizes the importance of implementing common reporting standards to ensure transparency and equality for all economic agents. At the same time, it places a greater focus on technological solutions in reducing compliance costs and the time required for tax reporting, while improving economic efficiency by providing greater certainty to taxpayers. Basic technologies to improve VAT administration (UN, 2024b) are e-invoicing, e-reporting and digital cash registers. A key enabler of improved VAT administration is the continuous sharing of information, either through tax authorities' access to bank account data or through the reporting of transaction-level information by sellers.

Considering the complexity and the time required for the rollout of substantial changes to VAT administration, granting greater access to tax authorities may reform the system more efficiently. This approach requires strengthening the State Tax Service of Ukraine's capacity to work with and secure large amounts of data. It is important to ensure the ease and convenience of VAT administration for entrepreneurs. The Ministry of Finance (2025) has already started working on automation and digitalization of VAT administration. It is essential to continue this work in 2026, so that by January 1, 2027, everything is fully prepared and well-communicated with VAT payers. Further details are presented in Section 4.

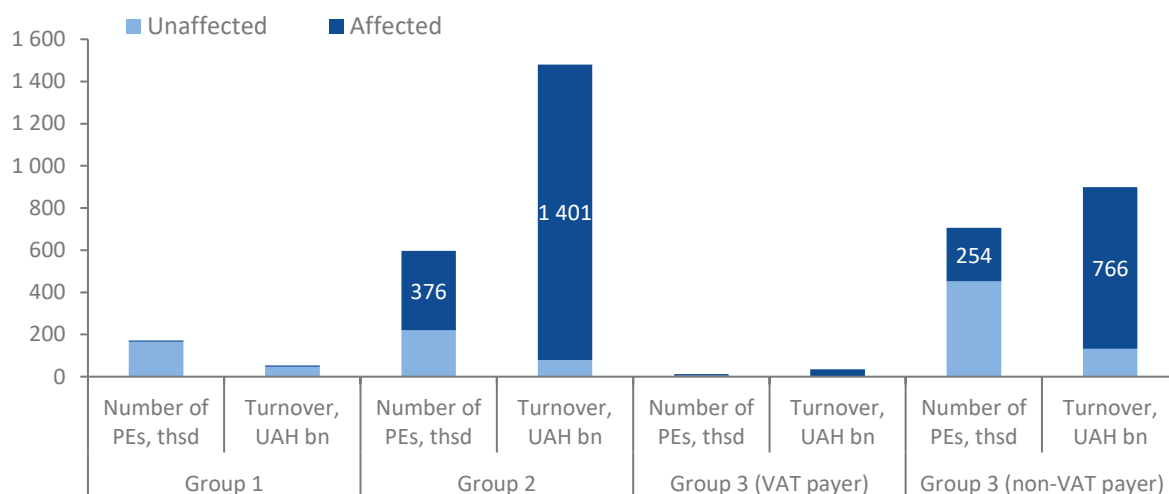
3.1 Impact analysis of the STS VAT reform

3.3.1 Impact assessment on group-by-group basis

Although the VAT registration threshold formally applies uniformly across all STS taxpayers, its effective impact is highly concentrated in specific segments of economic activity. As shown in Figure 17 the bulk of the reform's effect falls on Group 2 taxpayers and on non-VAT payers within Group 3, while Group 1 remains largely outside the scope of the reform and Group 3 (VAT payers) are already fully compliant. A detailed quantitative breakdown of the number of affected PEs and their turnover by STS group and sector is provided in Annex C.

Figure 17. The UAH 1 m VAT threshold primarily affects Group 2 PEs, covering around 63% of PEs and 95% of its turnover, and Group 3 PEs, affecting around 36% of PEs and 85% of its turnover

Effects of VAT introduction for STS taxpayers by number and turnover, 2024

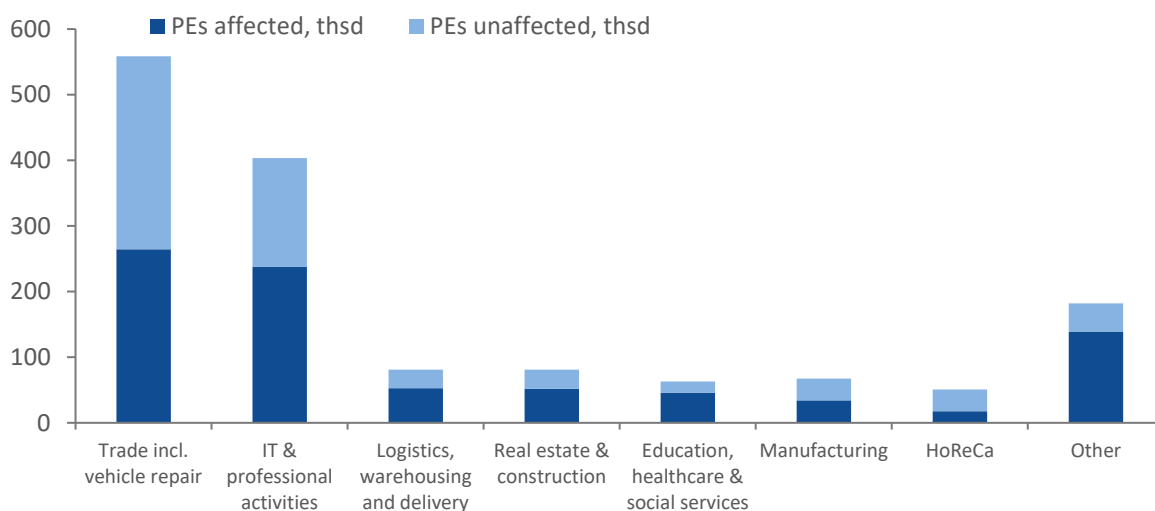


Source: Own representation based on State Statistics Service (2026), own estimate

Figure 18 Figure 18 presents the distribution of STS taxpayers affected by the UAH 1 m VAT threshold across economic activities, covering all STS groups jointly. The distribution highlights strong sectoral concentration of the reform's impact, particularly in trade, IT and professional services, logistics, manufacturing, and HoReCa - which mainly affects sectors identified in Section 2.2 as high-risk for abuse.

Figure 18. The VAT introduction will have the greatest impact on the trade and services sectors.

Sectoral distribution of STS private entrepreneurs affected and unaffected by VAT registration threshold, all groups combined, 2024



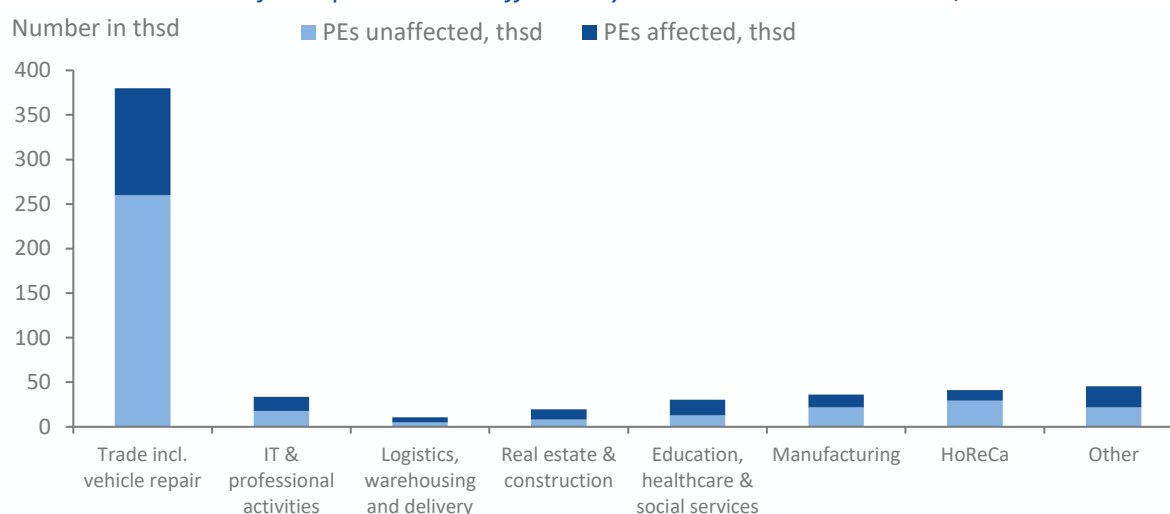
Source: Own representation based on State Statistics Service (2026), own estimate

This cross-group sectoral perspective helps explain the group-level results. Differences in impact across STS groups largely reflect their sectoral composition rather than features of the formal group design. In other words, the VAT threshold operates primarily through the type of economic activity and the position of taxpayers in goods and service supply chains. Against this background, the group-level effects can be interpreted more precisely. In Group 1, around 96% of taxpayers report annual turnover below UAH 1 m and therefore remain outside the VAT registration requirement. Only around 4% of

Group I taxpayers (approximately 6.1 thsd entities) are potentially affected, predominantly in trade incl. vehicle repair, and household services (see Annex C). The limited exposure of Group I is therefore driven by the proximity of the VAT threshold to the group's turnover distribution rather than by structural features of the regime. Even a moderate increase of the VAT threshold to the Group I turnover ceiling of UAH 1.3 m would entirely exclude this group from the reform. In 2024, mandatory VAT registration above the threshold would apply to around 63% of Group 2 taxpayers (approximately 376 TH entities), which together generate almost the entire turnover of the group (see Annex C). Sectorally, this impact is concentrated in trade, followed by HoReCa and manufacturing activities, as illustrated in Figure 19.

Figure 19. In Group 2, the strongest impact would fall on sectors with the highest abuse potential - trade (incl. vehicle repair), HoReCa, manufacturing

Sectoral breakdown of Group 2 PEs to be affected by the UAH 1 m VAT threshold, 2024



Source: Own representation based on State Statistics Service (2026), own estimate

These activities also correspond to the sectors with the highest indicators of system misuse documented in Section 2.3. In this context, the fragmentation and multiplication of private entrepreneurs is not a standalone phenomenon but a mechanism that supports business models based on undeclared turnover, grey imports, and non-transparent product origin. The core effect of the reform for Group 2 is the reintegration of goods-related activity into VAT chains, restoring invoice-based traceability and enabling cross-checks through VAT reporting. The impact will be most noticeable in the B2C segment, where final consumers will benefit from greater transparency and reliability of goods, knowing that products are authentic rather than grey market. At the same time, competition will be leveled, allowing compliant businesses to compete fairly. The transmission channel is described in detail in Section 3.2.2. Group 3 (VAT payers) are unaffected by definition, as they are already fully integrated into the VAT system. Non-VAT payers in Group 3, however, are significantly affected¹³. In 2024, VAT registration above the threshold would apply to around 36% of Group 3 taxpayers (approximately 254 000 entities), covering about 85% of the group's total turnover (around UAH 766 bn). This indicates that the reform targets economically significant activity rather than marginal self-employment. Sectorally, the impact is concentrated in IT and professional services, followed by wholesale and retail trade and logistics-related activities, as shown in Figure 20.

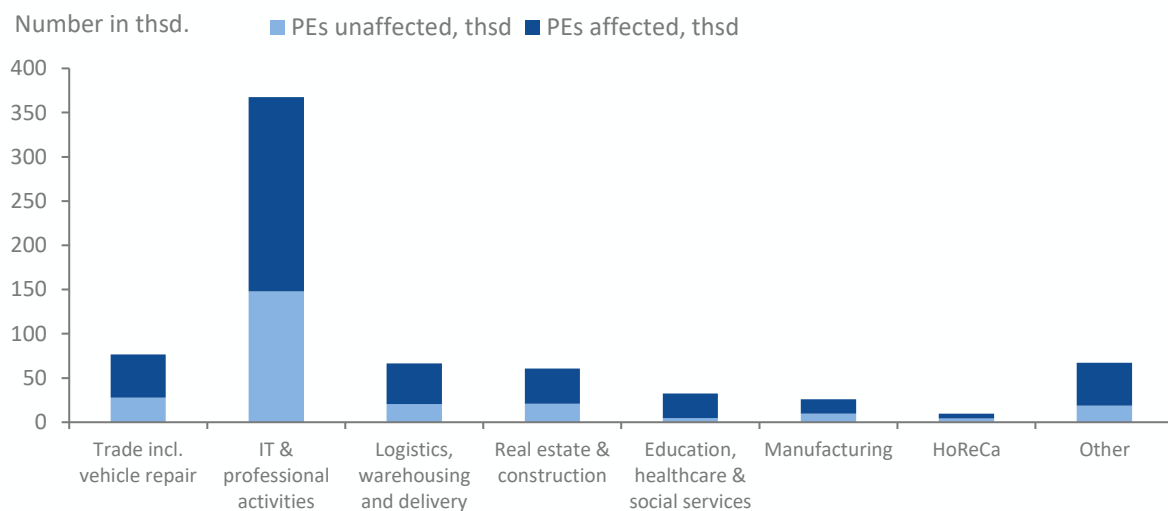
The impact of the VAT introduction on service segment (B2C and B2B) is described in 3.3.3. The VAT 1 m threshold doesn't imply to the STS actors, who's revenue is more than UAH 1 m. The VAT threshold is

¹³ In case VAT being introduced tax rate 3% for Group 3 will be the same for all PEs.

defined by the volume of taxable transactions, not by business turnover or VAT liability. This includes transactions taxed at the standard rate of 20%, reduced rates of 7% and 14%, as well as zero-rated transactions such as exports of goods and international transport. In addition, transactions exempt from VAT under Article 197 of the Tax Code are included in the threshold calculation, despite the absence of output VAT and the lack of entitlement to input VAT deduction. Moreover, revenue from transactions that are outside the scope of VAT (Article 196 of the Tax Code) as well as services supplied with a place of supply outside the customs territory of Ukraine (Articles 186.2–186.3 of the Tax Code) does not count toward the VAT registration threshold, which materially affects the effective coverage of the reform in service-oriented sectors.

Figure 20. In Group 3, the impact would be concentrated mainly in services, particularly B2B activities, as this group primarily interacts with VAT-registered counterparties

Sectoral breakdown of Group 3 PEs to be affected by the UAH 1 m VAT threshold, 2024



Source: Own representation based on State Statistics Service (2026), own estimate

This applies, in particular, to a wide range of services provided to non-residents, including IT and digital services, software development and testing, data processing, IT consulting, creative and intellectual services, advertising, legal, engineering and other professional services, as well as media and telecommunications services. At the same time, the scope of these exclusions remains fragmented and would benefit from further harmonisation, as discussed in Section 4. Within this context, the IT segment has access to an institutional alternative through the Diia City special legal regime introduced in 2021. Diia City offers a distinct business framework with different tax and labour instruments, reducing reliance on the widespread use of PEs under the STS. In addition, certain transactions carried out by Diia City residents, including the provision of educational and informational services in the field of information technology, are explicitly exempt from VAT under Article 197.1.33 of the Tax Code. Overall, VAT registration above the UAH 1 m threshold primarily affects taxpayers whose taxable transactions systematically generate substantial domestic turnover. For goods-based activities, this results in effective integration into VAT supply chains. For service-based and export-oriented business models, the actual impact depends on the composition of transactions and their VAT treatment. A detailed analysis of these differences for goods is provided in Section 3.3.2, and for services in Section 3.3.3. The distinctions between out-of-scope transactions, VAT-exempt transactions, and zero-rated supplies, and their respective treatment for VAT registration purposes, are summarized in

Table 2Error! Reference source not found..

Table 2. VAT treatment categories and their implications for the VAT registration threshold

Characteristic	Outside the scope of VAT (Article 196)	VAT-exempt transactions (Article 197)	Zero-rated transactions – 0% VAT (Article 195)
Included in the UAH 1 m VAT registration threshold?	No. As these transactions are not considered taxable supplies, they are excluded from the turnover calculation for mandatory VAT registration (Article 181.1).	Yes. Although no VAT is charged, these transactions are treated as taxable supplies under a preferential regime and are therefore included in the UAH 1 m threshold (Article 181.1).	Yes. These are taxable supplies subject to a 0% VAT rate and are fully included in the UAH 1 m threshold (Article 181.1).
Entitlement to input VAT deduction?	No. Input VAT on related purchases is not deductible. Where VAT was paid on inputs, compensatory VAT adjustments apply (Article 198.5).	No. Input VAT related to exempt supplies is not deductible and must be offset through self-assessed VAT adjustments (Article 198.5).	Yes. Full entitlement to input VAT deduction applies, including eligibility for VAT refunds where applicable (Article 195.2).
Sectors concerned	Financial and payment-related transactions. Export of services to non-residents where the place of supply is outside Ukraine under Articles 186.2–186.3, including IT and digital services (software development and testing, data processing, IT consulting), creative and intellectual services (design, digital content, audiovisual production), advertising services, consulting and professional services (legal, accounting, engineering), intellectual property creation and licensing, media and telecommunications services.	Licensed education services, healthcare services (excluding cosmetic procedures), book publishing and sales, selected cultural activities, certain social services, state and administrative services subject to duties, specific housing transactions, religious and charitable activities.	Exports of goods, international transport of passengers and freight, processing of goods for non-residents with subsequent re-export, duty-free trade, aircraft and vessel refuelling for international or special operations.

Source: Own representation based on State Statistics Service (2026), own estimate

3.3.2 Detailed impact on trade in goods

For goods-related activities, the main role of mandatory VAT is to restore traceability along the supply-chain mechanisms. VAT integrates customs clearance, invoicing, and input tax deduction, making legal origin and transaction history central to the taxation of goods. Under the STS without VAT, this link is broken - goods can be sold without invoices, without proof of origin, and without VAT being paid at earlier stages of the supply chain. This structural break in VAT chains allows goods to be marketed without traceable origin and without VAT being paid at upstream stages. This break also underpins the shadow business models discussed in Section 2.3, including the sale of smuggled, illegally imported, or undocumented goods through private entrepreneurs operating under the STS without VAT.

Before VAT registration, compliant simplified-system operators purchasing goods from VAT-registered suppliers bear VAT embedded in purchase prices but have no entitlement to input VAT deduction. For

Group 3 PEs, this means that reported turnover - including embedded VAT - becomes the base for the single tax. Consumption taxes are therefore capitalised into turnover and subject to additional taxation under the STS. In contrast, operators relying on smuggled or illegally manufactured goods avoid VAT entirely and pay only the single tax, creating a persistent fiscal asymmetry between compliant and shadow models. After VAT registration, VAT paid on purchases is reclassified from an element of turnover into an input VAT credit, reducing net VAT liabilities. This restores VAT's core function as a tax on value added, removes the structural advantage of shadow models, and preserves VAT neutrality within B2B supply chains. Exports of goods are subject to a 0% VAT rate. Although no output VAT is charged, full entitlement to input VAT deduction is retained. VAT paid along the domestic supply chain therefore does not become a cost and may be refunded, ensuring tax neutrality of exports and supporting the international competitiveness of Ukrainian producers. A key structural effect of the reform arises in import operations. Under the current framework, VAT at customs is payable regardless of VAT registration status; however, for non-VAT payers this payment is final and becomes embedded in the cost of goods.

Table 3. VAT treatment of goods transactions

Characteristic	Exports	Domestic market	Imports
Is VAT due?	Yes, at a 0% rate. Taxable supply subject to zero rating (Art. 195.1).	Yes. Place of supply is Ukraine (Arts. 185.1, 194.1).	Yes, at 20%, payable at customs upon import (Arts. 185.1, 206.1).
Included in the UAH 1 m VAT threshold?	Yes. Zero-rated supplies are taxable and included in the registration threshold (Art. 181.1).	Yes. Each payment or supply counts toward the mandatory registration threshold (Art. 181.1).	No at import stage; yes upon subsequent domestic sale (Art. 181.1).
Administration	Full. Customs declaration and VAT invoice at 0% rate required (Arts. 195.1.1, 201.1).	Full. VAT invoice registration in the Unified VAT Register and monthly reporting (Arts. 201.1, 203.1).	Limited. VAT payable at customs even by non-VAT payers (Art. 181.2).
Input VAT credit	Yes (refund entitlement). VAT paid on domestic inputs may be refunded (Arts. 198.3, 200.4).	Yes. Input VAT offsets output VAT liabilities (Art. 198.3).	Yes, but only for VAT-registered taxpayers. VAT paid at customs becomes input credit (Arts. 198.1, 201.12).
Impact on B2B customer	None.	Neutral if the customer is VAT-registered (credit available) (Art. 198.1).	Neutral (Arts. 198.1, 206.1).
Impact on B2C customer	None.	Price increase; final consumers cannot deduct VAT (Art. 194.1.1).	Price increase; VAT paid at import is embedded in price (Art. 206.1).
Macroeconomic effect	Stimulative: export support, FX inflows, refund entitlement (Arts. 195.1.1, 200.4).	Fiscal: direct taxation of domestic consumption (Art. 194.1).	Regulatory and de-shadowing: reduces scope for smuggled goods in domestic markets (Art. 181.2).

Source: Own representation based on State Statistics Service (2026), own estimate

At the same time, smuggled goods sold through non-VAT PEs avoid both import VAT and invoice-based traceability altogether, generating significant price advantages and strong corruption incentives. After VAT registration, VAT paid at customs ceases to be a fiscal burden and becomes an input VAT credit. As a result, the economic benefit of smuggling is reduced from full VAT avoidance to, at most, potential manipulation of customs valuation, substantially narrowing the space for shadow schemes.

Table 4. VAT treatment of imported goods: registered and non-registered taxpayers

Import and sales model	VAT at import (customs)	VAT on sale	Input VAT credit	Net tax effect for the PE	Economic / fiscal impact
Legal import via non-VAT PE (pre-reform)	Paid (20%), final	Not charged	None	VAT embedded in price; for Group 3 included in turnover and taxed under the single tax	Double fiscal burden on compliant PEs; reduced competitiveness of legal imports
Smuggled goods sold via non-VAT PE	Not paid	Not charged	None	No VAT; only single tax (or fixed payment in Group 2)	Artificially low prices, shadow market advantage, corruption incentives
Legal import via VAT-registered PE (post-reform)	Paid (20%), credited	Charged (20%)	Full credit	No net VAT burden; VAT excluded from single tax base in Group 3	Level playing field, reduced incentives for smuggling, restored VAT chain
Smuggled goods sold by VAT-registered PE (post-reform)	Not paid	Charged (20%)	None	Full VAT payable without credit; sharp increase in tax burden	Economic unviability of grey models; strong deterrence of illegal sales

Source: Own representation based on State Statistics Service (2026), own estimate

Overall, mandatory VAT registration for goods-related activities does not introduce a new systemic tax burden for compliant market participants. Instead, it transforms VAT already embedded in prices into a recoverable input credit. The primary fiscal and economic effects arise in B2C transactions, dealings with non-VAT payers, and business models linked to smuggling and non-transparent origin of goods. In these segments, the reform removes artificial price advantages, restores invoice-based traceability, and significantly narrows the scope for corruption and shadow practices.

3.3.3 Detailed impact on trade in services

While services are less embedded in physical supply chains and customs procedures than goods-related activities, VAT plays a central role in shaping incentives related to turnover transparency, contractual structure, and the organisation of economic activity. For domestically supplied services, VAT registration operates through invoice-based reporting and the inclusion of taxable turnover in the VAT system. In B2B transactions with VAT-registered counterparties, VAT remains economically neutral: output VAT charged by the supplier is fully creditable for the consumer and does not affect final prices or margins. By contrast, in transactions with final consumers (B2C) and with non-VAT-registered business customers, VAT cannot be passed further along the VAT chain and therefore remains embedded in prices. This generates a moderate net tax effect and contributes to the levelling of competitive conditions between VAT-registered providers and alternative legal forms of activity. This effect is particularly relevant in service sectors where the STS has been extensively used beyond genuinely small-scale entrepreneurship. In professional services, consulting, education, creative industries, and parts of the IT sector, the use of multiple PEs has often substituted for standard employment relationships or incorporated business forms. Mandatory VAT registration above the threshold reduces the fiscal advantages associated with operating outside the VAT system at economically significant scale, while preserving the core neutrality of VAT in B2B transactions. As a result, the reform addresses distortions

related to labour reclassification and artificial fragmentation of activity without introducing new taxes on productive value creation.

The impact of VAT on services is also shaped by the treatment of cross-border supplies. Under the current framework, services whose place of supply is determined to be outside the customs territory of Ukraine pursuant to Article 186.3 of the Tax Code are classified as outside the scope of Ukrainian VAT. This category includes a broad range of services typically supplied to non-resident clients, such as software development and testing, IT and digital services, consulting, engineering, advertising, intellectual property licensing, media services, and audiovisual production. Revenue from such activities does not count toward the VAT registration threshold, and no output VAT is charged. While this approach broadly reflects the destination principle applied in international VAT systems, the current scope of Article 186.3 remains fragmented and selective. As a result, VAT neutrality in cross-border service transactions is effectively preserved only for the specific categories of services listed in Article 186.3. In cases where the place of supply is determined to be within the territory of Ukraine, the application of VAT may create non-neutral outcomes for services supplied to non-resident clients, since foreign recipients typically cannot claim input VAT credits. In such situations, either the service provider absorbs the VAT by lowering the net price, or the foreign client faces a higher gross price. Further harmonisation of place-of-supply rules with international practice is therefore required. From a policy perspective, VAT registration in the services sector must balance two objectives. On the one hand, it should ensure competitive neutrality and reduce opportunities for underreporting domestic turnover. On the other hand, it should avoid imposing disproportionate compliance costs on genuinely small service providers, such as tutors, individual consultants, designers, or other self-employed professionals operating at low turnover levels. In this context, the level of the VAT registration threshold is a critical design parameter. A threshold set too low risks discouraging growth and formalisation among small service providers, while a moderately higher threshold would better reflect the income dynamics and cost structures typical of service activities. A threshold in the range of UAH 2–3 m would preserve the developmental function of the STS for genuinely small providers, while ensuring that economically significant service activity is brought into the VAT system once scale effects become relevant. The practical implications of these mechanisms across domestic and cross-border service transactions are summarised in Table 5.

Table 5. VAT treatment of services transactions

Characteristic	Place of supply outside (of customs territory) of Ukraine	Domestic supply of services	Services provided from outside Ukraine to Ukraine
Is VAT charged?	No, where the place of supply is outside Ukraine based on the customer's location (Article 186.3). Yes, if the service does not fall within the scope of Article 186.3.	Yes. The place of supply is Ukraine (Articles 185.1, 194.1).	Yes. VAT is self-assessed by the recipient in Ukraine under the reverse-charge mechanism (Articles 180.2, 208.1, 208.2).
Included in the UAH 1 m VAT registration threshold?	No, where the supply is outside the scope of VAT and therefore excluded from the registration turnover (Article 181.1).	Yes. Each payment is included in the turnover for mandatory VAT registration (Article 181.1).	No for the foreign supply itself; the VAT liability arises for the recipient irrespective of VAT registration status (Articles 180.2, 208.4).
Administrative requirements	Significant. VAT-registered suppliers must recalculate input-VAT every month based	Full. VAT invoice registration in the Unified Register and	Limited. Non-VAT payers submit a separate VAT

	on the ratio of services provided incl. VAT to services provided exempted from VAT	monthly VAT reporting (Articles 201.10, 203.1).	calculation; VAT payers report through the VAT return (Articles 208.4, 201.12).
Entitlement to input VAT deduction	No. VAT incurred on inputs becomes a business cost (Article 198.5).	Yes. VAT paid to suppliers is deductible against output VAT (Article 198.3).	No. Input VAT deduction does not apply under the reverse-charge mechanism (Articles 198.2, 208.2).
Impact on B2B customers	Neutral. No VAT is charged.	Neutral if the customer is VAT-registered, as VAT is fully creditable (Article 198.1).	Treated as a production cost for the recipient (Articles 208.4, 208.5).
Impact on B2C customers	Neutral. No VAT is charged.	Price increase, as final consumers cannot deduct VAT (Article 194.1.1).	Reflected in final prices through cost pass-through (Article 208.5).
Macroeconomic effect	Supportive. Encourages service exports, foreign currency inflows, and external competitiveness.	Fiscal. Revenue generation through taxation of domestic consumption.	Regulatory. Ensures taxation of services supplied by non-residents to the domestic market.

Source: Own representation based on State Statistics Service (2026), own estimate

A detailed table summarising the STS VAT reform's impact across key sectors within PE groups is provided in Annex E.

4. Implementation and its challenges

The introduction of mandatory VAT registration for taxpayers under the STS after exceeding the general threshold raises questions about compliance costs, business behavior, and possible macroeconomic consequences. For a correct assessment, it is important to separate common assumptions that do not follow from the logic of VAT from practical implementation issues that require decisions in the reform's design and administration.

Misalignment of the VAT Threshold with current economic conditions. The VAT registration threshold in Ukraine was set at UAH 1 m in 2015, reflecting the economic conditions and price levels of that period. At the same time, Ukraine operates two misaligned thresholds: the VAT registration threshold (UAH 1 m) and STS turnover threshold (UAH 8.3 m in 2024), which effectively functions as parallel VAT boundary (mentioned in 3.2.3). A unified and inflation-adjusted VAT threshold would help to localize splitting around a single point together as the increase of resources required for abusive schemes (more business entities) will make such behavior more detectable by State Tax Service and enforcement authorities. At the same time, keeping the VAT threshold too low would disproportionately affect genuinely small business. As noted in UN (2024a), the optimal VAT threshold should balance additional revenue gains against compliance and administrative costs, avoiding economic losses from over-registration while preserving the integrity of the VAT system. In this context, the threshold should be

calibrated to protect genuinely small businesses from disproportionate administrative burdens, while remaining sufficiently low to discourage artificial business fragmentation and to make such practices more visible and detectable. Properly designed, the VAT threshold functions not only as a fiscal parameter, but as a structural instrument that shapes incentives, transparency, and the effectiveness of tax enforcement. The IMF recommended Keen & Mintz framework (2004; see also Ebril et al., 2001) demonstrates that the VAT registration threshold should be set at the point where the welfare gain from additional VAT revenue equals the extra administrative and compliance costs. Within this framework the optimal threshold is the point where the marginal benefit of one more registrant equals its marginal social cost, calibrated by the following components:

$$\text{Optimal VAT threshold} = \frac{\delta A + C}{(\delta - 1)\tau v}$$

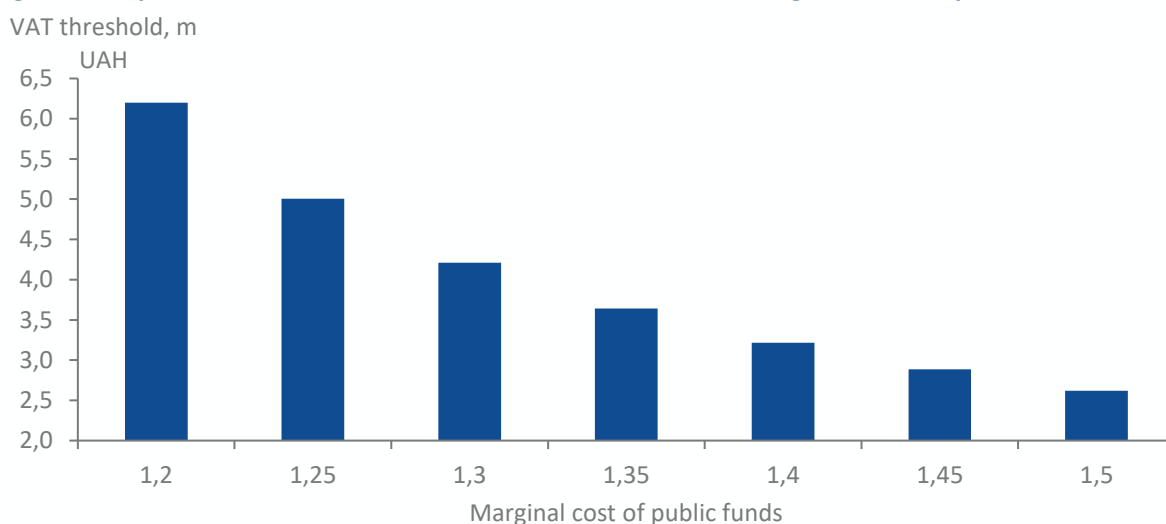
- Marginal cost of public funds (δ) - a benefit-cost ratio defined as the change in welfare in monetary terms of a policy divided by the change in net government expenditure⁴¹ and reflects how strongly the government values additional revenue relative to private income. For the marginal cost of public funds, the authors note that it should be greater than 1, and according to the OECD (2011), it is recommended to use a range of 1.2–1.5.
- Administrative costs (A) - additional costs for the tax authority per new registrant, that amounts to approximately UAH 18 thsd in 2024 data showing that 29% of full-time employment¹⁴ (FTE) at the State Tax Service is engaged specifically in registration, taxpayer services, returns (OECD, 2025b), and payment processing, and taking into account State Tax Service costs in 2024 and the number of VAT payers.
- Compliance costs (C) - costs borne by firms per registrant for bookkeeping, reporting, software, and advisory services. Based on a World Bank assessment (2024), for companies with turnover of UAH 1–8 m, this amounts to ca. UAH 75 thsd and around UAH 100 thsd at total level annually in 2024.
- VAT rate (τ) – standard VAT rate, which is 20%
- Share of value-added in sales (v) - a ratio derived as the value added of microenterprises relative to their total turnover, which amounts to 39% based on 2024 (State Statistics Service, 2026).

Administrative capacity and quality of law enforcement. Expanding the circle of VAT payers increases the requirements for the quality of administration and law enforcement. The current model in Ukraine relies heavily on transactional control of tax invoices, which, when attracting new payers, creates risks of discretionary decisions, delays in registration, and temporary liquidity gaps. With this architecture, even a formally neutral tax can generate indirect costs for businesses that are not related to the economic substance of the transactions. The practice in the EU, particularly in Poland, demonstrates a different focus of control: risk-oriented analysis of the taxpayer's financial flows as a whole, rather than blocking individual transactions. Although this model uses tough tools, including temporary account blocking, decisions are made at the taxpayer level and are based on aggregate risk indicators rather than formal characteristics of individual invoices. In the Ukrainian context, full replication of this model is currently limited, in particular due to the lack of automatic access by tax authorities to bank data. At the same time, even within the current system, the key task is to reduce discretion and shift control towards automated and predictable procedures. This involves expanding automatic criteria for conscientious taxpayers, simplifying reporting for new participants in the VAT system, and introducing digital tools that reduce compliance costs and minimize manual intervention. The risk of tax invoices being blocked remains one of the key practical challenges for entrepreneurs.

¹⁴ Full-time equivalent (FTE) is a unit of measurement indicating the workload of an employee, comparing their hours to a standard full-time position (Danao & Bottorff (2024)).

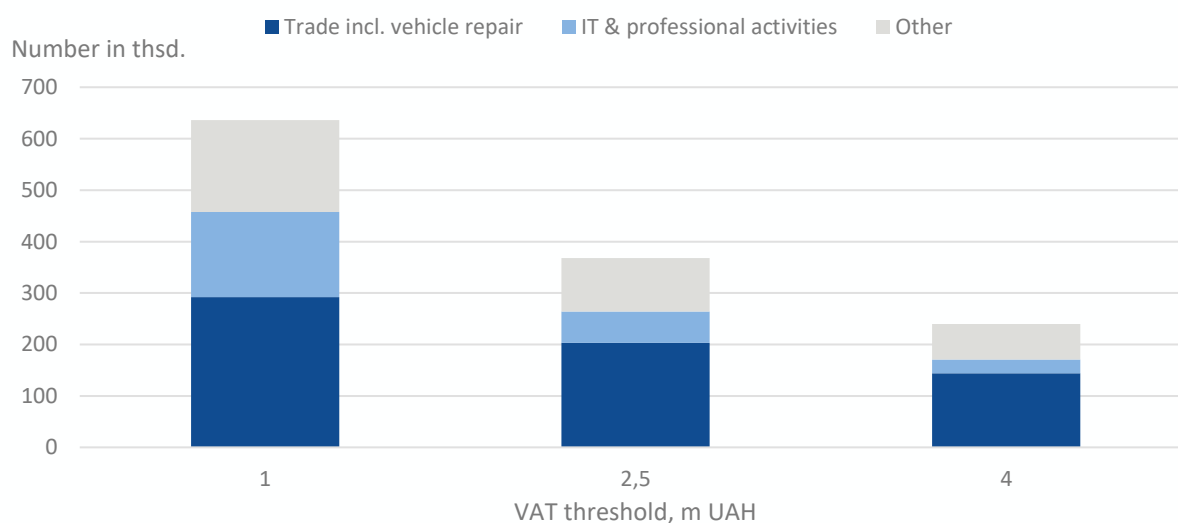
At the same time, the current monitoring system already includes automatic registration mechanisms for taxpayers with a positive tax history. In particular, invoices are registered without delay, provided that the total volume of supplies does not exceed UAH 3 m per month, supplies to one counterparty do not exceed UAH 500,000, and the manager does not engage in mass management of enterprises. Additional criteria for small, medium, and large businesses are set out in Appendix 2 to Resolution No. 1165 of the Cabinet of Ministers of Ukraine dated December 11, 2019. At the same time, as part of the preparation of the Anti-Corruption Strategy until 2030, proposals were developed to reduce administrative discretion in the area of invoice blocking. They provide for the detailing of risk criteria for payers and transactions, the definition of clear indicators and threshold values, as well as the fixation of the responsibility of officials for making decisions within automated monitoring systems. A separate element of implementation should be to improve the convenience of VAT administration for payers. This includes automating accounting processes, standardized digital solutions for reporting, and clear communication of rules. It is critical that these tools be implemented and tested before the circle of taxpayers is expanded, and that the transition be accompanied by clear explanations.

Figure 21. Optimal VAT threshold for Ukraine under different marginal costs of public funds, m UAH



Source: Own representation based on State Statistics Service (2026), own estimate

Figure 22. Number of PEs affected by the VAT threshold depending on its level



Source: Own representation based on State Statistics Service (2026), own estimate

Low level of business confidence in tax authorities. The reform may be perceived as increased pressure, even if its goal is to level the playing field. The risk is reduced through automated checks, risk-based models, the use of anonymized data analysis for case selection, as well as transparent technical access protocols and the recording of control grounds, which minimize manual intervention and informal requests.

Political resistance and delays in decision-making. The issue is sensitive for both sole proprietors and participants in the informal economy, and the interests of organized groups can slow down implementation or blur the design. The most sustainable approach is phased implementation with a predictable transition period, clear dates and rules, and communication that explains the logic of the changes through fairness and competitive neutrality rather than fiscal pressure.

Temporary underreporting of turnover or partial transition to the shadow economy during the transition period. During the adaptation phase, some entrepreneurs may not declare part of their revenue or reconsider their calculations. These effects weaken when the rules are introduced gradually and without sharp jumps in parameters, when the legal model remains competitive in terms of costs and risks, and when non-cash payment instruments become convenient even for small transactions.

Tax burden and effective rates. The claim that VAT registration automatically raises the tax burden on service providers to 20–22% is based on an incorrect interpretation of VAT as an income tax. In B2B transactions between VAT payers, the tax is neutral: the supplier's output VAT is credited by the buyer as a tax credit and does not change the margin. The net effect occurs in B2C or in sales to non-VAT payers, where VAT remains in the price, which is typical VAT logic in OECD countries. It is also important that under the current regime, VAT is often already present in business expenses as a non-deductible tax on purchases; after registration, it is converted into a tax credit. The obligation to register arises only after the threshold is exceeded, so the reform does not address small-scale self-employment but concerns economically significant activities. As a result, the key outcome is the equalization of fiscal conditions between legal entities and comparable models through sole proprietorships without VAT, particularly given that residents of Diya City as legal entities apply VAT on general grounds.

Behavioral responses of businesses. Fears of a “mass exodus” from the formal sector should be treated with caution. The VAT threshold primarily affects the transparency of accounting and the structure of interaction with counterparties, rather than the very fact of economic activity, if the costs of compliance are proportionate and administration is predictable. The potential for complete shadowing is lower in services than in trade in goods due to the role of contracts, reputation, and cashless payments in B2B and export segments. At the same time, the risks of adaptation due to temporary understatement of income or partial “removal” of transactions from accounting confirm the need for simple reporting, clear rules, and understandable explanations during the transition period.

Risks for microbusinesses in low-margin segments. The threshold level is a key parameter that determines the balance between formalization and the developmental function of the STS. A moderately higher threshold than the current level of UAH 1 m — in the UAH 2–3m range, with an indicative level of about UAH 2.5m — would better correspond to the typical income dynamics and cost structure of small entrepreneurs (especially in low-margin segments) and would reduce the risk of disproportionate compliance costs, while integrating economically significant activities into VAT after reaching scale.

5. Recommendations

1. Review the approach to determining the VAT exemption threshold. The threshold for mandatory VAT registration should be set at UAH 2.5 m, because:

- The average turnover of sole proprietors of all groups is UAH 1.7 m.
- The average turnover of sole proprietors of all groups (excluding those with an annual turnover of up to UAH 500 000) is UAH 2.7 m.
- The average turnover of sole proprietors of all groups (excluding those with an annual turnover of up to UAH 1 m) is UAH 3.4 m.
- The average turnover of sole proprietors engaged in wholesale and retail trade is UAH 2.2 m.
- In wholesale and retail trade, Group 2 shows an abnormal increase in the number of PEs, starting with a turnover of UAH 4.1 m. In HoReCa, Group 2 shows an abnormal increase in the number of PEs, starting with a turnover of UAH 4.6 m. **This indicates that the introduction of a threshold of UAH 4 m and above will not make the fragmentation scheme more expensive, effectively leaving it at the current level.** At the same time, the threshold should remain no lower than the limits for the smallest microbusinesses in the first group so as not to undermine the very logic of the STS. The fiscal implications depend on the final VAT threshold level and require further assessment, given potential spillover effects on both simplified and general tax systems.

2. Compensate for the expansion of VAT by reducing the administrative burden. The expansion of the circle of VAT payers should be accompanied by simplification of administration. For businesses operating under the simplified VAT system, it is advisable to use tools that reduce pressure on working capital, in particular the cash method. This allows microbusinesses to remain simple even after integration into the VAT chain.

3. Replace the selective list in Article 186.3 of the Tax Code with a unified place-of-supply rule for cross-border services, streamlining the determination of the place of service provision in line with international VAT practice.

4. Create fiscal space for a future reduction in the VAT rate for certain types of goods and services. After the war ends, it would be advisable to consider reducing the VAT rate, in particular for basic food products and certain socially significant goods, where the current rate is one of the highest in the EU. Such decisions are only possible after the restoration of the entire VAT chain, so that the reduction in the rate does not lead to budget revenue losses and distortions of competition.

5. Groups 1 and 2 should be merged into a single group. A key element of this reform should be the replacement of fixed single-tax payments with a mechanism that links tax liabilities to the taxpayer's actual turnover. Fixed payments disconnect the tax burden from the scale of economic activity. As a result, businesses with very different turnover levels face the same tax liability, weakening the link between economic capacity and taxation and creating distortions within the STS. Linking tax liabilities to declared turnover would preserve administrative simplicity while ensuring a more proportionate distribution of the tax burden across taxpayers with different levels of activity. Current turnover ceilings for Group 2 (UAH 6.7 m, approximately EUR134 000) and Group 3 (UAH 9.3 m, approximately EUR186 000) are low by both economic logic and international standards. Under Ukrainian legislation (Verkhovna Rada, 2025b) and Commission Recommendation 2003/361/EC (EU, 2003), a micro-

enterprise is defined as having annual turnover of up to EUR2 m (around UAH 100 m). In Poland, the simplified regime applies up to the same EUR2 m threshold, alongside a fully functioning VAT system.

Once fixed payments are replaced and a single mandatory VAT registration threshold is introduced, turnover limits within the STS should be revised upward. Under such a framework, the tax burden increases gradually with turnover, reducing incentives to artificially limit growth or to fragment business activity for tax purposes.

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Annexes

Annex A.

Table 1. Groups 1–3 simplified tax system and general taxation system description

Parameter	Group 1	Group 2	Group 3 (without VAT)	Group 3 (with VAT)	General taxation system (PEs)
Unified tax (2024)	Up to 303 UAH/month	Up to 1,420 UAH/month	5% of turnover	3% of turnover	–
Unified tax (2026)	Up to 333 UAH/month	Up to 1,729 UAH/month	5% of turnover	3% of turnover	–
Personal income tax	–	–	–	–	18% of gross profit
Military levy (2024)	800 UAH/month	800 UAH/month	1% of turnover	1% of turnover	5% of gross profit
Military levy (2026)	865 UAH/month	865 UAH/month	1% of turnover	1% of turnover	5% of gross profit
Social security contribution (2024)	1,760 UAH/month	1,760 UAH/month	1,760 UAH/month	1,760 UAH/month	22% of gross profit (ranging from 1 to 20 minimum wages)
Social security contribution (2026)	1,902 UAH/month	1,902 UAH/month	1,902 UAH/month	1,902 UAH/month	22% of gross profit (ranging from 1 to 20 minimum wages)
Employees	0	Up to 10	No limit	No limit	No limit
Annual turnover cap (2024)	UAH 1.186 m	UAH 5.921 m	UAH 8.286 m	UAH 8.286 m	–
Annual turnover cap (2026)	1.444 m UAH/year	7.212 m UAH/year	10.091 m UAH/year	10.091 m UAH/year	–
VAT registration	No	No	No	Yes	Yes, after a turnover of UAH 1 m

POS/PRRO ¹⁵	No	Yes	Yes	Yes	Yes
General restrictions on type of activity		<ul style="list-style-type: none"> – Organizing and conducting gambling and lotteries; – Money exchange; – Production, export, import, sale of excise goods; – Extraction, production, and sale of precious metals and stones; – Extraction and sale of minerals; – Financial intermediation activities, except for insurance activities; – Enterprise management activities; – Postal (except courier services) and telecommunications services; – Sale of art and antiques; – Activities related to organizing and conducting touring events; – Security activities; 			Any activities that are not prohibited by law
Group-specific restrictions on type of activity	Only retail sale of goods from market stalls and activities related to the provision of household services to the population are allowed	<ul style="list-style-type: none"> – Provision of intermediary services for the purchase, sale, lease, and appraisal of real estate; – Provision of Internet access; – Manufacture, supply, and sale of jewelry and household items made of precious metals and stones 	Only general restrictions on type of activities		Any activities that are not prohibited by law

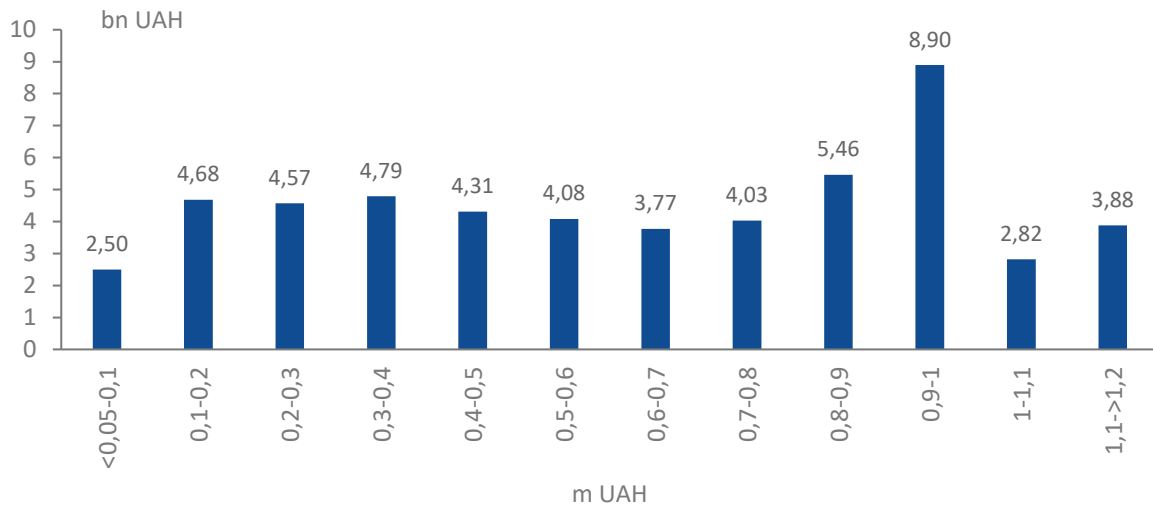
Source: Own representation based on State Statistics Service (2026), own estimate

¹⁵ Point-of-sale (POS) terminal is a hardware device used to process card payments and manage transactions at retail locations.

PRRO is a Ukrainian abbreviation for „cash register“, which is a software that records transactions, as well as generates and submits fiscal receipts to the State Tax Service.

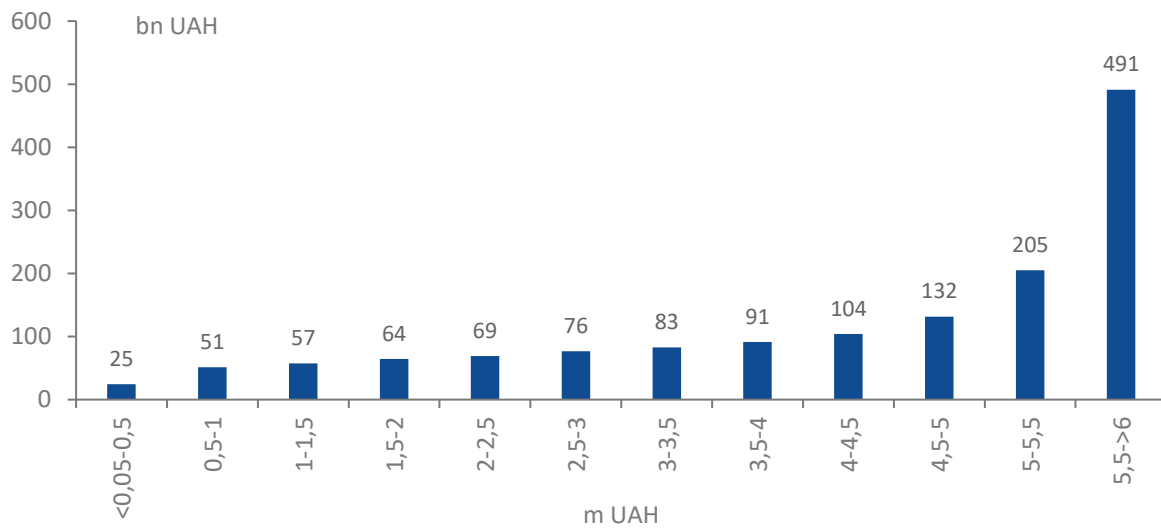
Annex B

Figure B1. Distribution of Group 1 PEs turnover, bn UAH



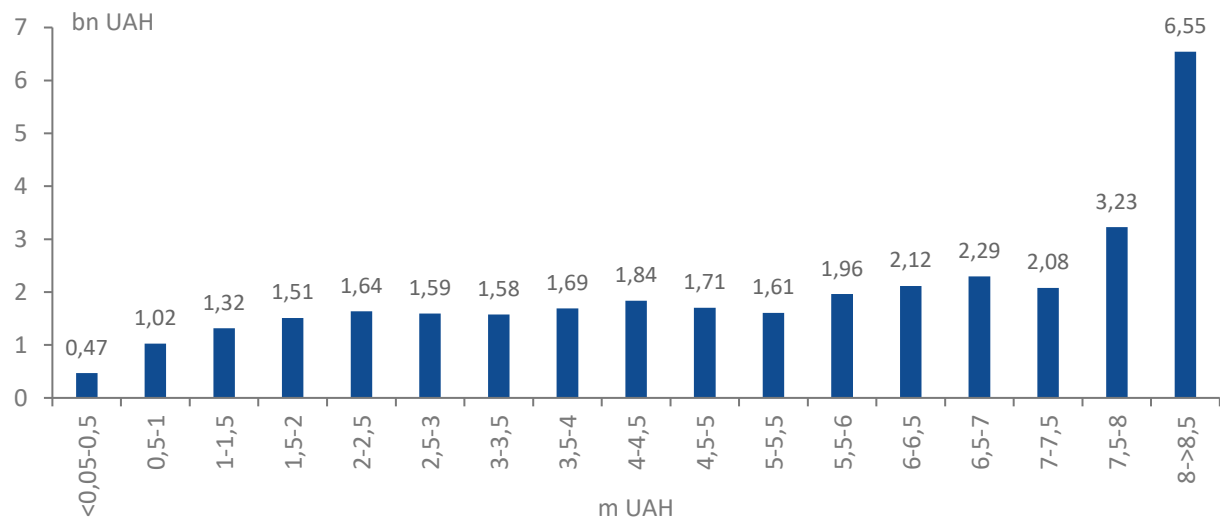
Source: Own representation based on State Statistics Service (2026), own estimate

Figure B2. Distribution of Group 2 PEs turnover, bn UAH



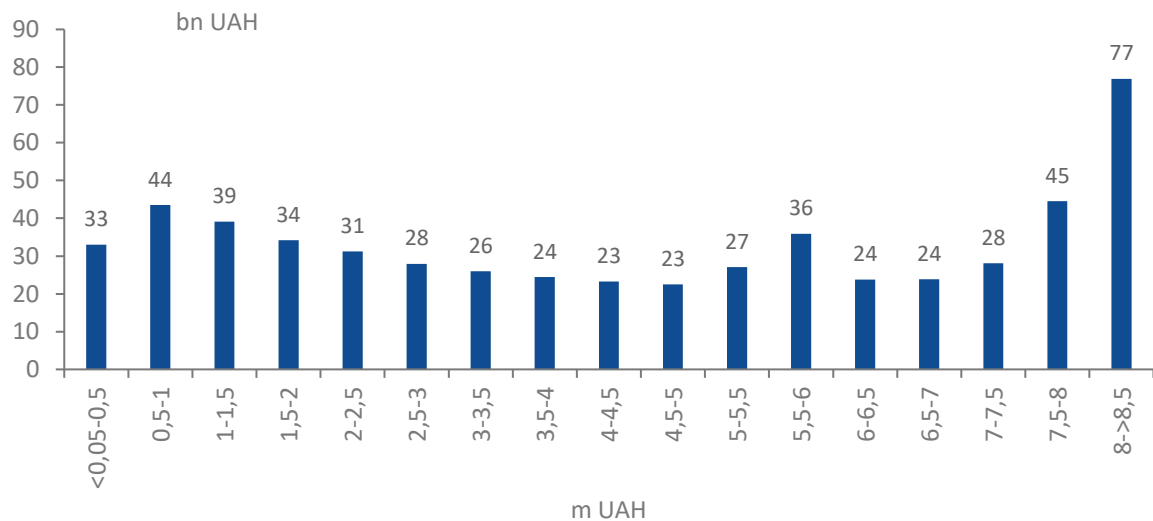
Source: Own representation based on State Statistics Service (2026), own estimate

Figure B3. Distribution of Group 3 PEs (VAT payers) turnover, bn UAH



Source: Own representation based on State Statistics Service (2026), own estimate

Figure B4. Distribution of Group 3 PEs (non-VAT payers) turnover, bn UAH



Source: Own representation based on State Statistics Service (2026), own estimate

Annex C

Table C1. Number of Group 1 PEs affected by VAT Introduction by sectors, based on 2024 data

Sections	Group 1 Number of PEs			Group 1 Turnover, m UAH		
	Total	Above 1 m VAT threshold	Share affected, % of total	Total	Above 1 m VAT threshold	Share affected, % of total
Agriculture, forestry and fisheries	226	5	0%	65	5	0%
Arts, sports, entertainment and recreation	44	2	0%	20	2	0%
Construction	62	2	0%	19	2	0%
Education	51	6	0%	17	7	0%
IT	78	13	0%	39	15	0%
Manufacturing	3 539	116	0%	975	129	0%
Professional, scientific and technical activities	1 725	113	0%	578	124	0%
Real estate	139	11	0%	61	12	0%
Water supply; sewage, waste management	6	0	0%	3	0	0%
Logistics, warehousing and delivery	133	7	0%	52	8	0%
HoReCa	139	8	0%	52	9	0%
Administrative and support	663	56	0%	224	62	0%
Healthcare and social help	176	6	0%	47	7	0%
Other services	66 706	1 362	1%	16 249	1 512	3%
Wholesale and retail trade	97 899	4 362	3%	35 532	4 827	9%
Mining and quarrying	0	0	0%	0	0	0%
Electricity, gas, steam and air conditioning supply	1	0	0%	0	0	0%
Finance services	13	0	0%	3	0	0%
Public administration and defence	1	0	0%	0	0	0%
Activities of households	5	0	0%	1	0	0%
Activities of extraterritorial organisations and bodies	0	0	0%	0	0	0%
Total	171 606	6 069	4%	53 936	6 720	12%

Source: Own representation based on State Statistics Service (2026), own estimate

Table C2. Number of Group 2 PEs affected by VAT Introduction by sectors, based on 2024 data

Sections	Group 2 Number of PEs			Group 2 Turnover, m UAH		
	Total	Above 1 m VAT threshold	Share affected, % of total	Total	Above 1 m VAT threshold	Share affected, % of total
Agriculture, forestry and fisheries	10 349	5 384	1%	19 519	17 818	1%
Arts, sports, entertainment and recreation	6 034	3 153	1%	12 111	11 141	1%
Construction	4 772	2 475	0%	8 896	8 150	1%
Education	11 911	4 455	1%	16 867	14 229	1%
IT	16 260	8 301	1%	30 730	27 592	2%
Manufacturing	35 987	21 920	4%	84 391	79 407	5%
Professional, scientific and technical activities	17 319	9 412	2%	34 913	31 958	2%
Real estate	14 752	5 551	1%	20 133	17 097	1%
Water supply; sewage, waste management	1 012	563	0%	2 289	2 155	0%
Logistics, warehousing and delivery	10 490	4 872	1%	18 353	16 620	1%
HoReCa	41 107	29 175	5%	119 795	115 658	8%
Administrative and support	6 095	3 557	1%	13 365	12 508	1%
Healthcare and social help	18 536	8 469	1%	29 426	25 833	2%
Other services	21 862	9 050	2%	32 453	28 433	2%
Wholesale and retail trade	379 962	259 856	44%	1 036 851	992 356	67%
Mining and quarrying	3	1	0%	2	1	0%
Electricity, gas, steam and air conditioning supply	23	16	0%	68	66	0%
Finance services	110	64	0%	229	218	0%
Public administration and defence	10	5	0%	26	24	0%
Activities of households	24	9	0%	29	27	0%
Activities of extraterritorial organisations and bodies	0	0	0%	0	0	0%
Total	596 618	376 288	63%	1 480 446	1 401 293	95%

Source: [State Tax Service](#), CES calculations

Table C3. Number of Group 3 (VAT payers) PEs affected by VAT Introduction by sectors, based on 2024 data

Sections	Group 3 (VAT payers) Number of PEs			Group 3 (VAT payers) Turnover, m UAH		
	Total	Above 1 m VAT threshold	Share affected, % of total	Total	Above 1 m VAT threshold	Share affected, % of total
Agriculture, forestry and fisheries	899	667	5%	3 398	3 331	10%
Arts, sports, entertainment and recreation	12	7	0%	29	28	0%
Construction	659	365	3%	1 477	1 396	4%
Education	2	2	0%	5	5	0%
IT	131	64	1%	246	225	1%
Manufacturing	1 937	1 213	10%	5 516	5 271	15%
Professional, scientific and technical activities	353	180	1%	673	609	2%
Real estate	144	83	1%	355	336	1%
Water supply; sewage, waste management	26	18	0%	75	72	0%
Logistics, warehousing and delivery	3 922	2 698	21%	12 257	11 856	34%
HoReCa	37	18	0%	63	60	0%
Administrative and support	350	197	2%	807	758	2%
Healthcare and social help	8	3	0%	12	12	0%
Other services	98	44	0%	152	133	0%
Wholesale and retail trade	4 077	2 298	18%	9 381	8 838	26%
Mining and quarrying	4	2	0%	13	13	0%
Electricity, gas, steam and air conditioning supply	3	1	0%	8	7	0%
Finance services	4	2	0%	10	10	0%
Public administration and defence	0	0	0%	0	0	0%
Activities of households	0	0	0%	0	0	0%
Activities of extraterritorial organisations and bodies	0	0	0%	0	0	0%
Total	12 666	7 862	62%	34 475	32 958	96%

Source: [State Tax Service](#), CES calculations

Table C4. Number of Group 3 (non-VAT payers) PEs affected by VAT Introduction by sectors, based on 2024 data

Sections	Group 3 (non-VAT payers) Number of PEs			Group 3 (non-VAT payers) Turnover, m UAH		
	Total	Above 1 m VAT threshold	Share affected, % of total	Total	Above 1 m VAT threshold	Share affected, % of total
Agriculture, forestry and fisheries	9 241	3 064	0%	12 619	11 417	1%
Arts, sports, entertainment and recreation	9 174	2 061	0%	8 762	6 973	1%
Construction	20 859	9 314	1%	36 678	33 529	4%
Education	17 256	2 071	0%	9 496	6 246	1%
IT	255 998	113 773	16%	324 457	270 395	30%
Manufacturing	25 803	9 821	1%	41 378	37 595	4%
Professional, scientific and technical activities	111 447	34 031	5%	123 540	99 757	11%
Real estate	39 694	11 439	2%	41 209	33 767	4%
Water supply; sewage, waste management	1 014	297	0%	1 191	1 048	0%
Logistics, warehousing and delivery	66 355	20 586	3%	83 745	72 096	8%
HoReCa	9 689	4 213	1%	21 199	20 137	2%
Administrative and support	29 305	9 061	1%	36 674	31 471	4%
Healthcare and social help	15 230	2 419	0%	11 034	8 043	1%
Other services	11 507	2 169	0%	9 342	7 665	1%
Wholesale and retail trade	76 621	27 693	4%	128 720	119 261	13%
Mining and quarrying	29	13	0%	54	50	0%
Electricity, gas, steam and air conditioning supply	75	38	0%	161	150	0%
Finance services	6 703	1 917	0%	7 619	6 714	1%
Public administration and defence	60	20	0%	94	82	0%
Activities of households	125	5	0%	26	20	0%
Activities of extraterritorial organisations and bodies	6	1	0%	3	2	0%
Total	706 191	254 006	36%	897 999	766 419	85%

Annex E.

Table E. Segments of the simplified tax system and reform impact on them

Segment	Affected entities, thous	Unaffected entities, thous	Impact assessment	Economic implications	Implementation considerations
Trade and auto repair, B2C (G2)	260	120	Businesses operating in the formal economy would account for VAT on the net basis, i.e. output VAT minus input VAT on documented purchases. Businesses relying on grey imports or undocumented inputs would not be eligible for input VAT deduction and would therefore bear the full 20% VAT on the gross sales price. Only taxable transactions (20%, 7%, 14% and 0%) are included in the mandatory VAT registration threshold, while transactions outside the scope of VAT under Article 196 are excluded.	Reduced attractiveness of grey import schemes and associated corruption risks in customs and tax administration. Consumer price effects are more limited in low-margin retail (food, FMCG) and more pronounced in high-margin segments. Reduced competition from grey imports partly or fully offsets the price effect.	VAT administration needs to be adjusted during the preparatory year to ensure that compliant SMEs can reliably claim input VAT without delays or blocking.
IT and professional services, B2B (G3)	148	220	Services are predominantly supplied to VAT-registered legal entities. The introduction of VAT is price-neutral for both the private entrepreneur and the client, as VAT is recovered	Largely neutral impact. Reduced incentives for disguised employment. Increased formal demand for capital goods and services (IT equipment, software and other	To preserve price neutrality, automatic and timely registration of input VAT is essential. In addition, the rules on cross-border supply of services should be unified, as Articles 186.2–186.3 do not

			<p>through input tax deduction. Private entrepreneurs become eligible for input VAT on business expenses. Services supplied to non-residents with the place of supply outside Ukraine (Articles 186.2–186.3) are outside the scope of VAT and are not counted towards the registration threshold.</p>	<p>investment inputs) that enter the VAT chain.</p>	<p>currently cover all services supplied to non-residents with the place of supply outside Ukraine.</p>
HoReCa (G2–G3)	33	17	<p>Businesses would account for VAT on value added and claim input VAT on formal purchases. VAT administration does not introduce a qualitatively new burden, as a large share of the sector already operates under complex internal structures due to business fragmentation.</p>	<p>Reduced incentives for grey imports and artificial fragmentation. Transition to single legal entities improves bankability and investment attractiveness. Higher prices may reduce consumer demand and trigger market adjustment.</p>	<p>A standard VAT framework without special regimes is required, with emphasis on the stability of input VAT deduction.</p>
Manufacturing (G2–G3)	32	30	<p>Manufacturers account for VAT on value added and deduct input VAT on raw materials and intermediate inputs. The share of value added is higher than in trade but lower than in HoReCa, resulting in a</p>	<p>Some increase in domestic prices may reduce demand, but this effect is offset by reduced competition from grey imports.</p>	<p>A review of reduced VAT rates for traditional craft production could be considered as a targeted industrial policy instrument.</p>

			moderate price effect.		
Healthcare, education and social services (G2–G3)	17	46	Core healthcare, education and social services are VAT-exempt under Article 197 of the Tax Code. Cosmetic services without medical indication, certain medical examinations and commercial services are taxed at the standard rate. Educational services provided by licensed institutions, including distance and IT-related education, are exempt. No input VAT deduction applies to exempt supplies.	Continued affordability of essential social services. The absence of VAT liability implies no entitlement to input VAT deduction, which is already reflected in existing business models.	Clear confirmation of the continued application of VAT exemptions is required, with no narrowing of their scope during reform implementation.
Real estate (G2–G3)	17	37	Long-term residential leasing is subject to VAT at the standard 20% rate for VAT-registered suppliers, with no general exemption. Short-term accommodation (hotels) is taxed at a reduced 7% rate. VAT on electronic booking services (Airbnb and similar platforms) is accounted for by non-resident suppliers under a special regime.	VAT increases the cost of formal rental services. In the context of a housing shortage, this constrains supply in the formal rental market.	Introducing a zero rate or exemption for long-term residential leasing would support formal housing supply.
Other B2C activities (G2)	47	48	VAT applies to most commercial	VAT is embedded in	Stable operation of the input VAT

			transactions. Exemptions are limited to socially significant goods and services (childcare products, medicines, books, public transport, funeral and selected public services). Exempt supplies do not allow input VAT deduction and require compensatory VAT adjustments.	final consumer prices. Formalisation of purchases reduces the effective tax burden through input VAT deduction.	mechanism and a clear distinction between taxable and exempt supplies are required.
Other B2B activities (G3)	76	155	Transactions with VAT-registered counterparties are price-neutral. VAT does not increase production costs and is fully offset through input VAT deduction.	Neutral fiscal impact, improved transparency and formalisation of costs.	Uninterrupted registration of input VAT is a key condition.
Micro-enterprises (G1)	6	166	In most cases, turnover does not reach the mandatory VAT registration threshold. A share of transactions is excluded from the threshold as they are outside the scope of VAT.	No material impact.	Preservation of the simplified non-VAT regime.
Other unaffected entities (G3, already VAT-registered)	0	13	No change in tax status.	None.	None.
Total	636	851			